99TH CONGRESS
2d Session

SENATE

REPORT
99-260

TAX REFORM ACT OF 1985

REPORT

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

together with

ADDITIONAL VIEWS

MARCH 13 (legislative day, MARCH 10), 1986.—Ordered to be printed

---

U.S. GOVERNMENT PRINTING OFFICE

58-289 O

WASHINGTON : 1986

S243-1

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

JAKE GARN, Utah, *Chairman*

JOHN HEINZ, Pennsylvania
WILLIAM L. ARMSTRONG, Colorado
ALFONSE M. D'AMATO, New York
SLADE GORTON, Washington
MACK MATTINGLY, Georgia
CHIC HECHT, Nevada
PHIL GRAMM, Texas

WILLIAM PROXMIRE, Wisconsin
ALAN CRANSTON, California
DONALD W. RIEGLE, JR., Michigan
PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
ALAN J. DIXON, Illinois
JIM SASSER, Tennessee

M. DANNY WALL, *Staff Director*
KENNETH A. MCLEAN, *Minority Staff Director*
JOHN C. DUGAN, *Counsel*
THOMAS J. LYKOS, *Counsel*
LINDA C. ZEMKE, *Counsel*

CONTENTS

	Page
I. Introduction	1
II. Findings and conclusions	2
A. Retroactive effective date	2
B. Safety and soundess of financial institutions	2
C. Housing affordability	3
D. Community development through tax-exempt financing	3
E. The international competitiveness of U.S. financial and manufacturing institutions	3
III. Overview of testimony	4
A. Effective date provisions	4
B. The safety and soundness of financial institutions	4
C. Housing affordability	5
D. Community development through tax-exempt financing	6
E. The international competitiveness of U.S. financial and manufacturing institutions	8
IV. Detailed summary of testimony	9
A. Safety and soundess of financial institutions	9
B. Housing affordability	15
C. Community development through tax-exempt financing	19
D. The international competitiveness of U.S. financial and manufacturing institutions	28
E. Other provisions	34
Additional views of Senators D'Amato, Mattingly, Hecht, and Riegle for loan loss reserves	35
Additional views of Senators D'Amato, Mattingly, Hecht, Gramm, Dodd, and Sasser on tax-exempt financing	37
Additional views of Senator Gorton	42
Additional views of Senators Proxmire, Cranston, and Sarbanes	44

99TH CONGRESS
2d Session

SENATE

REPORT
99-260

TAX REFORM ACT OF 1985

MARCH 13 (legislative day, MARCH 10), 1986.—Ordered to be printed

Mr. GARN, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

together with

ADDITIONAL VIEWS

I. INTRODUCTION

On December 17, 1985, the House of Representatives passed H.R. 3838, the "Tax Reform Act of 1985." If enacted this bill would overhaul the Internal Revenue Code for the stated purposes of promoting "tax equity, simplification, and economic efficiency." The bill would shift taxes from individuals to corporations, and, while purporting to "reduce the interference of the tax system in the efficient allocation of resources in the economy," would nevertheless "preserve a number of * * * business incentives that were found to be beneficial to the economy and society." *See* Tax Reform Act of 1985, Report of the Committee on Ways and Means, House of Representatives, Dec. 7, 1985, at 55-62 (hereinafter cited as "House Committee Report").

Many of H.R. 3838's proposed changes would, if enacted, have a significant impact on economic sectors and issues within the jurisdiction of the Senate Committee on Banking, Housing, and Urban Affairs. Accordingly, the Committee asked more than 60 organizations and trade associations from the financial services industry, the housing industry, State and local governments, and manufacturers to comment on the tax bill's potential effects on their members. On the basis of these comments, the Committee conducted hearings on February 4, 5, and 6, 1986, that addressed the impact the bill would have on the safety, soundness, and competitiveness of these industries and governments.

In holding these hearings, the Committee acknowledged that it has no jurisdiction over tax legislation, which is solely the province

of the Senate Finance Committee. The purpose of the hearings was to inform that Senate Committee and the full Senate through a complete hearing record of the particular impact of H.R. 3838 on the areas within this Committee's jurisdiction.

The Committee requested comments from organizations and trade associations representing a broad cross-section of the financial, housing, and manufacturing industries, as well as State and local governments. In previous oversight and legislative hearings, these groups have typically presented both favorable and unfavorable views of a given legislative proposal. Regarding H.R. 3838, however, the groups that testified or responded with comments were virtually unanimous in their assessment: as it applies to them, H.R. 3838 dismally fails to simplify the Tax Code or make it either more fair or more efficient.

Furthermore, the bill repeals or changes incentives that Congress has expressly "found to be beneficial to the economy and society" or that "promote useful objectives," which are the standards set by the House Ways and Means Committee in justifying its preservation of other tax incentives. *See* House Committee Report at 60. Specifically, the consensus of the testimony was that the bill's provisions would undermine four undeniably "useful objectives" of primary concern to this Committee: (1) the safety and soundness of financial institutions; (2) housing affordability; (3) community development through tax-exempt financing; and (4) the international competitiveness of U.S. financial institutions and U.S. exports.

Accordingly, this Committee makes the findings and conclusions set forth below, followed by an overview of hearing testimony, a detailed summary of the testimony, and additional views of Committee members.

II. Findings and Conclusions

Although it does not concur with every statement of the witnesses, the Committee makes the following findings and conclusions:

A. RETROACTIVE EFFECTIVE DATE

The January 1, 1986 effective date of H.R. 3838 is having an immediate and serious effect on the ability of State and local governments to issue tax exempt securities to finance community development. The retroactive effective date is also deterring acquisitions of troubled thrift institutions by healthy financial institutions.

B. SAFETY AND SOUNDNESS OF FINANCIAL INSTITUTIONS

The safety and soundness of financial institutions and the financial system are threatened by the provisions in H.R. 3838 that:

1. Repeal special rules for troubled thrift institutions, which facilitate and promote their acquisition by healthy institutions;
2. Repeal the deductibility of loan loss reserves for banks with over $500 million in assets; and
3. Repeal special net operating loss provisions that now both permit smaller financial institutions to compensate for their inability to diversify loan portfolios and specifically permit

thrift institutions to carry forward heavy losses incurred in the early 1980's.

C. HOUSING AFFORDABILITY

The affordability of housing for low- and middle-income taxpayers, both buyers and renters, and the level of housing construction in the short-run would both be seriously impaired by the provisions of H.R. 3838 that:

1. Repeal the Accelerated Cost Recovery System, which would substantially raise the cost of capital to finance housing construction;
2. Cap the amount of both tax-exempt mortgage revenue bonds, which would raise the cost of ownership for first-time home buyers, and multifamily industrial development bonds, which would raise both the cost of ownership for first-time home buyers and the cost of constructing rental housing;
3. Apply the alternative minimum tax to otherwise tax-exempt interest from multifamily housing bonds and to deductions for the difference between 30-year and 40-year depreciation from housing investment, both of which would seriously dampen investment in rental housing;
4. Limit interest deductions for a particular year, which would also limit the overall amount of investment in rental housing; and
5. Change the method for itemizing deductions so as to reduce the benefit of all deductions, which for most taxpayers primarily consist of housing expenses.

D. COMMUNITY DEVELOPMENT THROUGH TAX-EXEMPT FINANCING

H.R. 3838's 160 pages of restrictions on the ability of State and local governments to issue tax-exempt bonds will make legitimate governmental projects either substantially more expensive or economically unfeasible. Issuers that depend on tax-exempt funds to finance public purpose projects will be adversely affected by the provisions of H.R. 3838 that: (1) characterize bonds issued for many types of public purpose projects as "nonessential"; (2) apply more stringent volume caps than those imposed by current law; (3) apply the alternative minimum tax to traditionally tax-exempt bonds; (4) modify well-established rules relating to arbitrage, rebate, and advance refundings; and (5) require that bond proceeds be expended within certain predetermined time periods without regard to the actual needs of the issuer.

E. THE INTERNATIONAL COMPETITIVENESS OF U.S. FINANCIAL AND MANUFACTURING INSTITUTIONS

H.R. 3838 will immediately and seriously affect the ability of U.S. companies to compete in world markets through provisions that:

1. Repeal the accelerated cost recovery system and the investment tax credit, which would critically impair capital formation for basic, strategic, capital-intensive industries; and

2. Restrict the ability of financial institutions to use the foreign tax credit and defer foreign income tax, which would seriously hamper the ability of these institutions to compete in foreign markets; significantly reduce lending to developing countries and thereby frustrate the Baker initiative to restructure Third World debt; and adversely affect U.S. exports by increasing the cost of critical export financing, further shrinking the U.S. share of foreign markets with the accompanying increase in the trade deficit and loss of U.S. jobs.

III. Overview of Testimony

This section of the report provides a short overview of the testimony received. It begins with the issue of retroactive effective dates, which is not repeated in the detailed summary of testimony.

A. EFFECTIVE DATE PROVISIONS

The most immediate concern of H.R. 3838, which affects several of the four public policy objectives discussed below, is its retroactive effective date of January 1, 1986. Notwithstanding that ultimate passage of a tax bill resembling H.R. 3838 is at best uncertain, these effective date provisions are already causing severe distortions to particular sectors of the economy. The market for new State and local bonds, for example, has virtually evaporated, and testimony revealed that the retroactive date has already: (1) resulted in a precipitous drop in the volume of new issues of tax exempt bonds (in the first 6 weeks of 1986 compared to 1985 the number and dollar amounts of exempt bond issues dropped from 432 to 98 and $11.3 billion to $3.4 billion respectively); (2) caused school districts to cancel bond sales; (3) in recent weeks has precluded major purchasers of tax-exempt bonds from bidding on general obligation bonds; and (4) caused a decline in the construction of rental housing.

Acquisitions of troubled thrift institutions by healthy financial institutions have also been seriously deterred by provisions, effective January 1, 1986, that repeal certain special tax provisions for thrifts. Likewise, the financing of U.S. exports has already been affected by retroactive provisions of H.R. 3838 denying U.S. banks foreign tax credits for gross foreign withholding taxes.

At the Committee's hearings, the testimony repeatedly emphasized that it is grossly unfair for one House of Congress to pass effective date provisions that distort economic behavior on the basis of proposed changes that may never become law; it is the equivalent of enacting a temporary statute without the Senate's consent.

B. THE SAFETY AND SOUNDNESS OF FINANCIAL INSTITUTIONS

At a time when many financial institutions are in severe financial straits, the witnesses testified that at least three provisions of H.R. 3838 would directly threaten the safety and soundness of the country's financial system.

1. Special Rules for Troubled Thrifts.—In 1981, Congress enacted three special tax rules to facilitate and promote the acquisition of troubled thrifts by healthy institutions. Section 804 of H.R. 3838 re-

peals these rules. This would, in the opinion of the Federal Home Loan Bank Board, "have a devastating effect on its ability to arrange supervisory mergers * * * H.R. 3838 will devastate the weak elements of the thrift industry and further jeopardize the basic solvency of the Federal Savings and Loan Insurance Corporation Fund." According to William Seidman, Chairman of the Federal Deposit Insurance Corporation, Congress should not repeal these thrift provisions but should instead amend the Tax Code to provide similarly favorable treatment to acquisitions supervised by the FDIC.

2. Deduction for loan loss Reserves.—Bank regulators require financial institutions to establish loan loss reserves in recognition of the fact that a predictable portion of a loan portfolio will deteriorate over time and become uncollectable. Like depreciation allowances, tax deductions for contributions to loan loss reserves recognize current real declines in economic value.

Under current law, all financial institutions are allowed a tax deduction for contributions to loan loss reserves. H.R. 3838 would deny this deduction to banks and bank holding companies with more than $500 million in assets. These institutions, moreover, would be required to pay taxes on previous deductions for contributions to reserves.

FDIC Chairman William Seidman and Federal Reserve Chairman Paul Volcker told the Committee that these provisions in H.R. 3838 would be detrimental to the safety and soundness of this select group of financial institutions, as the provisions would be contrary to economic reality and would impede their ability to establish adequate reserves.

Witnesses before the Banking Committee also criticized these provisions of H.R. 3838 for violating tax equity: the tax deductions would continue to be available to smaller banks and thrifts, but they would be arbitrarily denied to larger banks.

3. Net Operating Losses.—Current law permits financial institutions to carry net operating losses [NOL] back 10 years and forward 5 years, but section 803 of H.R. 3838 would substitute the rule applied to other corporations of a 3-year carryback and 15-year carryforward. Favorable NOL treatment is especially important for smaller financial institutions that are subject to regulated minimum capital requirements and have sustained heavy losses in particular years because of their inability to diversify their loan portfolios, for example, agricultural banks and community savings and loans.

Witnesses testified that without current NOL provisions, temporary economic problems in agriculture, timber, oil, and other localized sectors of the economy would drive the capital of banks and savings institutions below regulatory minimums. The result would be reduced banking services in local communities or mergers that would result in less competition or increased concentration of banking resources.

C. HOUSING AFFORDABILITY

The Tax Code has long sought to promote affordable housing for all Americans, both buyers and renters. H.R. 3838 recognized the

validity of this goal, at least in part, through its preservation of certain deductions for homeowners mortgage interest. According to the testimony, however, other provisions directly undermine this goal.

1. Repeal of Accelerated Cost Recovery.—Title II of H.R. 3838 would repeal the Accelerated Cost Recovery System. According to the testimony, such changes will act as a powerful deterrent to investment in housing, particularly multifamily, low-income rental housing. This will in turn raise its ultimate cost to renters.

2. Tax-Exempt Financing.—As discussed more fully below, title VII of H.R. 3838 imposes a number of restrictions on tax-exempt financing. Witnesses testified that two provisions will have a particularly adverse impact on the ability to obtain affordable housing. Section 145 would cap the amount of mortgage revenue bonds that States and municipalities could issue to lower the cost of ownership for first-time buyers. Similar caps will seriously limit the issuance of multifamily industrial development bonds, which in turn will raise substantially the cost of constructing rental housing.

3. Alternative Minimum Tax.—Section 501 of H.R. 3838 applies a minimum tax to income that is reduced below the 25-percent rate by certain specially defined "tax preferences." Included as a "tax preference" are certain interest deductions for investment in real estate. According to the testimony, the application of this provision would seriously dampen investment in real estate by individual investors, which again would raise the cost of rental housing significantly.

4. Interest Deduction Limitations.—Section 402 of H.R. 3838 would cap the amount of interest deductions that a taxpayer could deduct in a particular year ($10,000 plus investment income). Like the alternative minimum tax, this will significantly lower the overall amount of investment in rental housing, which will raise the cost of its construction substantially.

5. Itemized Deductions.—Under current law, to determine the deduction that can be taken from gross income, taxpayers who itemize must subtract an amount determined by their filing status from the sum of expenses that are deductible. H.R. 3838 would increase the amount to be subtracted by $500 for each family member.

The result would be to reduce the income tax benefit from each dollar that is eligible to be deducted. Since housing expenses are usually the majority of deductible expenses for most taxpayers, this provision of H.R. 3838 would reduce the value of the deductibility of housing expenses, especially to larger families. The result would be to increase the real cost of homeownership to larger families.

D. COMMUNITY DEVELOPMENT THROUGH TAX-EXEMPT FINANCING

H.R. 3838 was desinged to "result in a fairer distribution of the tax liability and a more efficient allocation of the economy's resources." These goals were to be accomplished by revisions to the tax code that would preserve those incentives that are beneficial, while eliminating others found to be ineffective or abusive. The Ways and Means Committee justified H.R. 3838's revisions to tax-exempt financing by noting its concern "that the large volume of nongovernmental tax-exempt bonds and the accompanying ability

of higher income taxpayers to avoid paying income tax erodes confidence in the equity of the tax system, increases the cost of financing traditional Government activities, and results in an inefficient allocation of new capital." (House Committee Report at 514.) Its purpose was to correct these problems without affecting the ability of State and local governments to raise funds for operations or government facilities.

While the stated objectives of the Ways and Means Committee are laudable, the consensus of the testimony was that H.R. 3838 falls short of fulfilling them. During the hearings witnesses offered compelling evidence that demonstrated the substantial harm H.R. 3838 would inflict upon State and local governments. This testimony demonstrated that title VII of H.R. 3838 would increase the costs of Government financing, promote the inefficient allocation of capital, result in the erosion of the country's infrastructure, and fail to restore public confidence in the tax system, all without contributing significant revenues to the Treasury. For example, H.R. 3838 has already prevented the State of Georgia from issuing $307 million in general obligation bonds and has prohibited various not-for-profit organizations in the State of New York, including hospitals, from initiating modernization projects.

The adverse effects of H.R. 3838 are not limited to the impairment of State and local governments' ability to finance public purpose projects. Several witnesses questioned whether H.R. 3838 represents an unwarranted encroachment on the powers the United States Constitution reserves for the States. These critics claim that H.R. 3838 violates fundamental principles of federalism by seriously eroding the doctrine of reciprocal intergovernmental tax immunity embodied in the Constitution.

Moreover, H.R. 3838 imposes complex and costly recordkeeping requirements on issuers and conditions tax-exempt status upon requirements that often are beyond the issuer's control. For example, the State of Georgia's constitution requires that proceeds from a bond issue be in hand before any contracts are signed to spend the funds; at the same time, H.R. 3838 would require that 5 percent of all bond proceeds be spent within 30 days of receipt. It would be nearly impossible for Georgia to satisfy both requirements.

In sum, witnesses representing a broad cross-section of affected individuals and institutions reached the following conclusions. First, rather than remedy perceived abuses, H.R. 3838 will so increase the cost of financing public purpose projects that many of them will become economically unfeasible. Second, the combination of the tax-exempt provisions of H.R. 3838, the reduction in Federal revenue-sharing programs, and the burdens confronting local governments through spending cuts precipitated by the Gramm-Rudman Act place State and local governments in an untenable position; that is, at a time when State and local governments are in the greatest need of relatively inexpensive sources of debt financing, H.R. 3838 will deny them access to this market. Finally, the witnesses questioned whether the imposition of this financial burden on State and local governments and the erosion of well-established principles of federalism could be justified by the marginal revenues these provisions may raise.

E. THE INTERNATIONAL COMPETITIVENESS OF U.S. FINANCIAL AND MANUFACTURING INSTITUTIONS

The hearings identified two types of provisions in H.R. 3838 that will immediately and seriously affect the ability of U.S. companies to compete in world markets.

1. Repeal of Accelerated Cost Recovery.—According to the testimony, H.R. 3838 would seriously impair capital formation through its repeal of the investment tax credit and the Accelerated Cost Recovery System. Continued incentives to invest in plant and equipment are not only critical to future U.S. competitiveness, but are necessary to preserve basic, strategic, capital-intensive industries.

2. Impediments to International Competitiveness of U.S. Financial Institutions and U.S. Exports in Foreign Markets.—Two related aspects of current law help U.S. institutions, particularly financial institutions, to compete in foreign markets: the foreign tax credit and the deferral of tax payable on foreign income. H.R. 3838 would significantly reduce the benefit of both provisions.

a. Reduction in Foreign Tax Credit.—The United States taxes U.S. persons on their worldwide income. In order to prevent double taxation of a U.S. person's foreign income, the U.S. allows a credit for foreign taxes on that income which can be applied against U.S. tax liability. To prevent the foreign tax credit from offsetting U.S. taxes of U.S. income, the foreign tax credit is limited to the amount of U.S. tax on foreign source income. Under current law the limitation is calculated on a worldwide or "overall" basis, in which income from all foreign sources is grouped together in determining the limitation.

Singling out banks and other financial institutions for special treatment, section 602 of H.R. 3838 would deny U.S. banks foreign tax credits for gross withholding taxes on foreign loans in excess of the U.S. tax on the net interest income of such loans. The effect would be to eliminate a credit for a portion of the foreign taxes paid on interest from loans to borrowers in foreign countries and consequently to increase the total tax burden on those loans. The stated purpose of the provision is to prevent banks from making otherwise uneconomic loans solely for tax reasons, and remove any tax incentive that stimulates lending overseas rather than in the United States.

Witnesses from banks and foreign trade groups strongly objected that the proposed change unfairly discriminates against banks; that it limits their ability to compete with financial institutions from such countries as Japan and the United Kingdom that have tax credit systems comparable to the current U.S. system; that it will adversely affect U.S. exporters, which are dependent on U.S. financing of their exports; and finally, that is will strongly discourage the very type of foreign lending to developing countries that the so-called Baker initiative is seeking to encourage.

b. Repeal of Deferral of Tax Payable on Foreign Income.—Current law permits U.S. banks to defer payment of tax on foreign income until dividends are repatriated to the United States. Section 621 of H.R. 3838 would instead require banks to pay tax on foreign-source income at the time it is earned. Like the changes to the foreign tax credit, this change would directly impair the ability of U.S. banks

to compete in foreign markets because, according to one witness, "No other home country of major international banking institutions imposes such a tax." Foreign subsidiaries of U.S. financial institutions seeking to build their capital base abroad through retained earnings would find themselves at an untenable competitive disadvantage: they would have to pay tax on their retained earnings to two separate governments. Moreover, U.S. exporters would face a loss of trade and export credit services from U.S. financial institutions, thereby increasing the difficulty of their competing in world markets.

IV. Detailed Summary of Testimony

This section provides a detailed, section-by-section summary of the testimony received on each of the issues discussed above. For each relevant provision, a brief explanation of current law and the changes of H.R. 3838 is followed by the major comments of the witnesses.

A. SAFETY AND SOUNDNESS OF FINANCIAL INSTITUTIONS

According to the testimony received, at least three provisions of H.R. 3838 directly threaten the safety and soundness of particular financial institutions and the financial system as a whole. These are the repeal of special tax rules for acquiring financially troubled institutions; the repeal of deductions for contributions to loan loss reserves; and the repeal of special net operating loss provisions. On the basis of this testimony, the Committee is especially concerned that the quest for tax neutrality may have run roughshod over targeted incentives that are critically important to maintaining public confidence in financial institutions.

1. Special Rules for Troubled Thrifts.—In 1981, Congress adopted three special tax rules for financially troubled thrift institutions to promote their acquisition by healthy financial institutions: (1) assistance payments to a troubled thrift by the Federal Savings and Loan Insurance Corporation [FSLIC] are not treated as either taxable income or contributions to capital; (2) the merger or acquisition of a troubled thrift is treated as a tax-free reorganization where the Federal Home Loan Bank Board certifies that the thrift is financially troubled; and (3) the requirements to avoid limitations on net operating loss carryovers under a tax-free reorganization are considered met when a troubled thrift is involved.

Section 804 of H.R. 3838 would repeal these special rules, effective January 1, 1986, because they give "beneficial treatment to a selected class of beneficiaries." House Committee Report at 595.

During the hearings, witnesses strongly objected to the proposed repeal. The original objective of the special tax rules, enacted in 1981, was to promote acquisitions of troubled thrifts and avoid institutional failures that would directly threaten the safety and soundness of savings institutions generally. Unfortunately, the problems that inspired these special rules have not gone away.

Every witness representing a savings and loan constituency, as well as the FSLIC itself, testified that the repeal of the tax rules for troubled thrifts embodied in section 804 of H.R. 3838 would have a devastating effect on the ability of the FSLIC to deal with

troubled institutions. Witnesses from the U.S. League of Savings Institutions stated that section 804 would "make virtually impossible the resolution of problem cases at the FSLIC." Other witnesses commented that the FSLIC is faced with a continuing number of failing institutions, while at the same time, resources and alternatives for handling these institutions are dwindling.

Perhaps the most troubling comments were those submitted by the FSLIC itself:

> [Repealing the troubled thrift provisions] will have a devastating effect on the Federal Home Loan Bank Board's ability to arrange supervisory mergers and will lead to enormous strains on the FSLIC insurance fund. It will practically eliminate potential acquirers willing to work with the Board on supervisory transactions. The result will be a drastic increase in the cost of resolution of defaulted institutions. This will, in turn, place the insurance fund under more critical stress than it already faces. In the Board's opinion as regulators, H.R. 3838 will devastate the weak elements of the thrift industry and further jeopardize the basic solvency of the insurance fund.

The agency added that the continuation of current tax law for financially troubled institutions is "crucial to the Federal Savings and Loan Insurance Corporation and to public confidence in the Nation's financial institutions."

Rather than repealing these special rules, several witnesses recommended that they be continued and expanded to include institutions insured by the Federal Deposit Insurance Corporation [FDIC]. Under current law, only FSLIC assistance payments are exempt from treatment as taxable income or contributions to capital. However, the FDIC insures and provides assistance to some thrift institutions, namely mutual savings banks, and witnesses urged that this assistance be treated the same as FSLIC assistance. In a letter to Chairman Garn, FDIC Chairman Seidman endorsed this recommendation:

> [T]he President's Tax Reform Proposal recommends that the special tax treatment of FSLIC assistance and reorganizations be continued through 1991. We support this extension, and suggest that, in the interim, the Code should be modified to make clear that FDIC payments to financial institutions are likewise not subject to tax.

2. Deduction for Loan Loss Reserves.—Under current law, all financial institutions are allowed a tax deduction for contributions to loan loss reserves. The agencies that regulate financial institutions require the establishment of these reserves, and contributions to these reserves reduce financial institutions reported income.

Under section 801 of H.R. 3838, commercial banks and bank holding companies with more than $500 million in assets would not be allowed tax deductions for contributions to loan loss reserves. Banking organizations above the $500 million threshold also would be required to pay taxes on previous deductions for contributions to reserves, as those deductions would be required to be "recaptured" into earnings over a 5-year period.

The stated rationale for these changes is that a tax deduction should be allowed for a loan loss only when a lender actually writes off a specific loan. Other financial institutions, however, would be treated differently by H.R. 3838. Thrift institutions would still be permitted to use the reserve method for tax purposes, although on a more limited basis, and banks with under $500 million in assets would still be able to use the reserve method as provided for by current law.

In a letter to Chairman Garn to be included in the Banking Committee's hearing record on H.R. 3838, Chairman Seidman of the FDIC expressed his opposition to changing the provisions on loan loss reserves: "Taking the reserve method away from large banks does not eliminate a preference. Rather, it denies deductions for one of the most significant expenses that banks are presently incurring and weakens the safety and soundness of many institutions in an industry that already has more than its share of troubles."

Federal Reserve Board Chairman Volcker told the Committee in a subsequent hearing that eliminating the deduction for contributions to loan loss reserves would make it more difficult for banks to maintain adequate reserves. B.F. Backlund, president of the Independent Bankers Association of America, similarly told the Committee that the provisions on loan loss reserves "would have a seriously adverse impact on the safety and soundness of the Nation's banking industry." As a result of the proposed change, according to Backlund, it will become "more costly and burdensome for banks to maintain these reserves (and banks will) be in a much weaker position to withstand sudden losses and widespread recession."

Walter V. Shipley, speaking on behalf of the New York Clearing House Association, told the Committee that eliminating large-bank deductions for contributions to loan loss reserves "would impair the capital positions of banking institutions and would cause an improper matching of the income from a loan portfolio with the losses that are inherent in that loan portfolio."

Banks are required to set aside reserves in recognition of the fact that some portion of their loan portfolios deteriorate over time and become uncollectible. When these loans are eventually written off, they are charged against loan loss reserves. In testimony before the Committee, Donald T. Senterfitt, the president of the American Bankers Association, emphasized this point in explaining the rationale for the establishment of loan loss reserves:

> The use of a reserve for loan losses allows banks to deduct the decline in value as it occurs rather than waiting until the loan has become completely worthless. The concept is very similar to allowing a manufacturing concern to deduct its investment in machinery over time through depreciation rather than at the time the machine becomes worthless.

Mr. Shipley added a parallel with tax deductions for decreases in the value of inventories: "Deductions for decreases in the value of inventories are recognized where the decreases occur and are not deferred until the inventories are sold."

Thomas P. Maletta, speaking on behalf of the American Financial Services Association, told the Committee that: "When a portfo-

lio of loans is made, the percentage which will not be repaid is reasonably estimative and represents a realized credit loss. If the amount and certainty of credit losses in a portfolio are reasonably known by proven experience, it is appropriate to recognize the loss."

Like Mr. Senterfitt, Mr. Shipley emphasized to the Committee that, "a bad debt reserve is not a reserve for future losses; but for present losses inherent in a loan portfolio at a given time." Mr. Senterfitt added the following examples:

> [T]he present depression in the agricultural sector has made it difficult for many farmers to pay back loans. Some will and others will not. Banks do not know which farmers will succeed and which will not. Banks do know, however, that the collateral value of farm land, crops, and equipment has declined significantly. The loan loss reserve concept allows banks to recognize the decline in value of farm loans without having to identify and charge off which particular loans will not be repaid. These same problems are present today in the oil fields of Texas, Oklahoma, and Colorado, in the timber industry of Oregon, and even in the silicon valleys of California.

This example highlights the fact that elimination of tax deductions for contributions to loan loss reserves would have serious negative effects on borrowers as well as on banks. Under current law, a bank can continue to work with a troubled agricultural or energy borrower while still taking tax deductions for contributions to reserves that reflect the deterioration in the bank's loan portfolio.

Under H.R. 3838, the tax deductions would not be available until the loans were actually charged off. According to the testimony, this would make it more expensive for banks to work with troubled borrowers and would cause banks to call loans sooner. In troubled industries like agriculture and energy, witnesses testified that property foreclosures would be accelerated, leading to more properties being sold sooner with concomitant additional downward pressure on property values.

The hearings also revealed that the policy underlying the proposed repeal is at odds with the expressed policies of bank regulators. The testimony pointed out that the Federal financial regulatory agencies consider the maintenance of adequate loan loss reserves essential in maintaining the healthy operation of individual banks and thrifts, and the industry as a whole. Faced with widely publicized bank failures and near failures as well as other institutions holding loan portfolios from industries which are themselves troubled, the regulators have actively encouraged and required institutions to increase their capital ratios, a major portion of which consists of loan loss reserves.

Mr. Backlund of the Independent Bankers Association of America noted the irony of H.R. 3838's proposed repeal of the reserve method and the exhortations of regulatory agencies to increase reserves:

> [A]t a time when the banking agencies are encouraging banks to boost their overall capital ratios and to increase

> loan loss reserves, it is inconsistent * * * to be moving in the opposite direction by making it more costly and burdensome for banks to maintain these reserves.

Another problem with the proposed bad debt reserve repeal is that failure to make contributions to loan loss reserves would initially overstate true bank income. Mr. Senterfitt told the Committee that if banks are denied a tax deduction for contributions to reserves they "will no longer be able to deduct the economic losses that they incur. They may well become the only American industry with significant levels of prepaid taxes on their balance sheets."

The significance of this prepaid tax issue was further explained by J. Thomas Macy of Price Waterhouse. In testimony on behalf of the American Institute of Certified Public Accountants, Mr. Macy explained that, as banks increasingly shift to a net prepaid tax position because of loan loss reserve additions for which no deduction is allowed, "these tax prepayments may have to be charged as a reduction of earnings and, therefore, as a reduction of bank capital" * * * "This problem will be significantly exacerbated by the House bill's repeal of the loan loss reserve deduction for banks with assets in excess of $500 million."

In other testimony, several witnesses emphasized that the reserve method of providing for bad debts is an economically sound principle that has been recognized for 65 years in the tax law and is recognized by generally accepted accounting principles, established banking industry practice, bank regulatory agencies, the SEC, bank financial analysts, bank shareholders, the marketplace, and the public at large.

Congress also has specifically recognized the importance of loan loss reserves. When legislation was enacted in 1983 to increase the U.S. contribution to the International Monetary Fund, Congress included provisions for "special reserves" to be held against commercial bank loans to countries experiencing repayment problems.

Additional testimony emphasized that supervision by bank regulatory authorities and the Securities and Exchange Commission ensures that reserve accounting for banks closely parallels expected bad debt losses. In fact, a publication by the staff of the Joint Committee on Taxation in 1983 observed that the additions to the loan loss reserves for financial accounting were then higher than amounts allowed for tax purposes, dispelling the notion that the reserve method is a "tax shelter." As the witness from the New York Clearing House Association concluded, "the House bill would make tax policy and accounting diverge from * * * sound bank regulatory and financial accounting principles."

On a related point, Mr. Macy noted in his testimony that "the adoption of a book/tax conformity requirement would provide a more rational system for determining the bad debt reduction for banks than either the House bill or present law." In strongly recommending that the Congress adopt such a requirement with respect to bank loan loss reserves, Mr. Macy referred to a bill introduced by Senators Roth and Boren (S. 1263).

H.R. 3838 also significantly alters the tax treatment for loan loss reserves of savings and loan associations. For many years, thrifts have been allowed to take a deduction for additions to loan loss re-

serves equal to 40 percent of taxable income, as long as they maintained a significant portion of their loan portfolio in qualifying real estate related investments. Under current law, these investments must constitute 82 percent (72 percent for mutual savings banks) of a thrift's assets. H.R. 3838 reduces this 40 percent deduction to 5 percent, contingent upon 60 percent of a thrift's assets remaining in housing related investments. H.R. 3838 does not apply the recapture provisions to thrift institutions.

Witnesses at the hearing expressed their support for the absence of a recapture provision for thrifts, and the U.S. League endorsed the bad debt reserve proposal in H.R. 3838. The National Council of Savings Institutions, however, expressed their concern that a 60-percent asset test requirement was too high a price to pay for the retention of a 5-percent deduction. At a minimum, they suggested that the qualifying assets be broadened to include powers granted to thrifts under the Garn-St Germain Depository Institutions and Deregulation Act.

3. Net Operating Losses.—Under current law, financial institutions that incur net operating losses may deduct those losses against income from their prior 10 years of operations and, if necessary, against income during the next 5 years. The ability to deduct a loss against previous income is important because it often enables a financial institution to receive a refund from the Internal Revenue Service in the year a loss is incurred, rather than in subsequent years.

Section 803 of H.R. 3838 would replace these provisions with a shortened 3-year carryback and a lengthened 15-year carryforward. The stated justification for this change is that it would bring the treatment of financial institutions into conformity with the treatment of nonfinancial corporations.

Mr. B.F. Backlund, president of the Independent Bankers Association of America, told the Committee that there are sound economic reasons for continuing the current differential treatment of financial institutions.

The current 10-year loss carryback provisions are particularly important in enabling smaller banks to avoid failure, for smaller banks are usually heavily dependent on a localized economy. A rural bank, for example, will often be highly dependent upon the local agricultural economy. If temporary problems beset the local agricultural economy, the rural bank often will find losses, not only in its agricultural loans, but also in its loans to local suppliers to farmers. As a result, a rural bank that may have a long history of profitability can be hit with sudden losses that are large enough to drive the bank's capital below regulatory minimums.

If the rural bank can immediately offset this temporary loss against income earned over the previous 10 years, the bank may be eligible for a refund from the IRS that will be sufficient to enable the bank to meet minimum regulatory capital requirements. This would be far less likely if the bank could immediately offset its loss only against income earned during the previous 3 years.

In testimony before the Committee, Donald F. Senterfitt, president of the American Bankers Association, emphasized that, given the current problems in the Farm Belt, now is not the time to reduce the ability of agricultural banks to immediately offset losses

against previous years' income. If a bank were closed because it could not offset sudden, temporary losses against previous income and thereby meet minimum regulatory capital requirements, the bank's community might very well be left without banking services. At the very least, competition would be reduced.

Enabling banks to continue operations by offsetting losses against previous income to meet capital requirements can also be important to limiting the impact of temporary economic problems on a community. If a rural bank fails because some local agricultural producers have problems, the remaining healthy producers may have their loans called and have no alternative sources of credit. Collateral for the failed bank's loans must be sold, and this typically drives already-depressed land values down even further. The overall result can be a downward economic spiral.

On the other hand, if a small bank can survive a temporary problem in its local economy through the use of loan loss carrybacks, the damage to the bank and community may be contained.

Witnesses for the United States League of Savings Institutions and the National Council of Savings Institutions, representing over 3,500 thrift institutions across the country, echoed the sentiments expressed by representatives of community banks and expressed strong reservations about any restrictions on the use of net operating losses for their industry. Thrift institutions experienced severe economic losses resulting from interest rate fluctuations in the late 1970's and early 1980's, which drastically affected their portfolios of fixed-rate mortgages and caused industrywide losses. Consequently, as one witness pointed out, "the losses experienced by thrift institutions from 1970–82 caused many institutions to use the entire 10-year carryback and move into the 5-year loss carryforward." Current net operating loss rules have provided the same benefits accorded small banks, enabling thrifts to generate more direct cash flow because of the tax benefits, and cushion unforeseen losses which resulted from past inflation.

According to the testimony, the net operating loss rules have proven to be a tool for thrifts as they restructure their portfolios and recover from losses incurred in recent years. However, the interest environment facing thrifts remains uncertain. According to the witnesses, the rationale for continuing present net operating loss rules for the industry remains compelling for at least a while longer. The U.S. League recommends granting thrift institutions an 8-year carryforward rule for losses incurred between 1981 and 1985. The National Council recommends a 3-year extension of the 5-year carryforward for losses incurred during these years. Both thrift advocates consider an extension of the rules essential "if thrift institutions are to complete the recovery and the restructuring now taking place."

B. HOUSING AFFORDABILITY

Testimony on housing issues addressed the effect of H.R. 3838 on both owners and renters. Witnesses reminded the Committee of the Federal Government's long-standing policy of promoting the "American Dream" of homeownership through tax incentives such as the deductibility of property taxes and mortgage interest. Like-

wise, the Tax Code has long provided incentives to invest in multi-family housing in order to foster decent low-cost rental housing to low- and moderate-income Americans. According to the testimony, the result has been that nearly two-thirds of Americans own their own homes, while the remaining one-third rent. Americans' housing conditions have improved over the last several decades, in part because of these incentives.

Against this background, witnesses testified that H.R. 3838 would substantially reduce many of the incentives that lower the cost of both owning and renting. The consensus was that all of the House tax bill's provisions that have an impact on housing, six of which are discussed below, do so negatively. Mr. Koelemij, immediate past president of the National Association of Home Builders, succinctly summarized the likely effects of H.R. 3838 on rental housing:

> Rental housing must be available for those who are financially unable * * * to own their own home. * * * Rental housing would not be an attractive investment without tax incentives. Absent tax incentives, availability of rental housing would decline and cost of renters would increase. * * * We need a consistent tax policy that maintains our national commitment to affordable, quality housing—both for homeownership and for rental housing.

According to the National Association of Realtors, H.R. 3838, if enacted, would increase the after-tax cost of owning a home by as much as 13 percent. The Home Builders Association forecast that rents for newly constructed apartments could be over 20 percent higher than what they would have been without H.R. 3838.

1. Repeal of Accelerated Cost Recovery.—Under current law's Accelerated Cost Recovery System [ACRS], an investor may recover the cost of investment in eligible property by using an accelerated rate of depreciation over a 19-year period. (This is usually considerably shorter than the asset's useful life.) H.R. 3838 proposes a straight-line method of depreciation over a longer span of 30 years under the Incentive Depreciation System [IDS] (accelerated depreciation would still be allowed for low-income housing).

The witnesses testified that the IDS proposal would have an almost immediate chilling effect on the construction of, or investment in, rental housing.

Mr. Ronald F. Poe, president of the Mortgage Bankers Association, explained in his written statement that, "the time value of money makes the larger depreciation deductions in the early years (or ownership) worth more to an investor than greater gains in later years. * * * Constant tinkering with the cost of the recovery system has a deleterious effect on investment in housing." The National Association of Realtors added: "Thirty-year straight-line depreciation is more harsh than the capital recovery rules applicable prior to 1981, when investment in new rental housing stagnated, rental vacancy rates declined and rents increased sharply."

2. Tax-Exempt Financing.—Under current law, mortgage revenue bonds as well as multi-family IDB's have tax-exempt status, and are each subject to separate annual volume limits for each State. The MRB's are intended to assist communities in aiding homeowners whose income might otherwise preclude them from

buying their own home. Multi-family IDB's encourage the construction of available and affordable rental housing. Because of the unique service rendered to communities and their less-advantaged residents by the MRB's and IDB's, they are placed under separate volume caps. Additionally, the MRB Program will expire at the end of 1987, unless Congress enacts legislation to the contrary.

Section 701 of H.R. 3838 removes the tax-exempt status of these bonds, as is discussed more fully below. Section 701 would also lump MRB's and IDB's with other "nonessential" bonds under an umbrella volume cap for all competing uses. The rationale for removing tax-exempt status and imposing the umbrella volume cap is derived from the "esssential/non-essential" definitional distinction that is discussed in more detail in the next section. The result is that the interest on many traditional public purpose bonds would become taxable to investors.

According to the testimony, the result of these changes would have serious, negative effects on investment in MRB's and IDB's, as well as on the construction of multi-family housing.

Mr. Koelemij commented on the proposal saying, "this lumping together under a unified volume cap would result in approximately a 47-percent reduction in MRB activities compared to 1985 levels. * * * There should be a separate volume limitation for MRB's."

Witnesses testified that the bill would reduce the availability of mortgages for first-time homebuyers whose interest rate is 2 percentage points or more below the market rate. Mr. Maffin of the National Association of Housing Redevelopment Officials characterized MRB's as "subsidy bonds (for) first-time buyers whose income would not otherwise allow them to purchase their own home."

The major problems that the witnesses identified with the provisions specific to single-family bonds were subjecting them to a tougher cap on volume of bonds issued and further restricting the income of homebuyers who could qualify.

In his testimony, Mr. Koelemij commented on removing the tax-exempt status and separate volume cap for IDB's:

> Due to costs of construction in recent years, virtually all new rental housing for low- and moderate-income households was financed with State and local IDB's often joined with Federal rent subsidies. * * * Until H.R. 3838, bonds issued for multi-family residential housing were under fewer restrictions than apply to other IDB's.

Mr. Brenneman claimed that, due to IDB's coming under the proposed "nonessential" volume cap, "volume restrictions will severely cut back the use of IDB's." In addition, Mr. Maffin testified that "establishing such a cap would significantly and adversely affect a number of communities using these bonds to produce housing with a set aside for low-income persons." Other witnesses strongly agreed that multi-family IDB's, like single-family MRB's, should remain under a separate volume cap, and all targeting be accomplished by the states and local communities.

Mr. Driesler of the National Multi-Housing Council summarized these points:

> To deem these bonds "nonessential" would create a sharp decrease in new construction of rental housing * * * renewed rental housing shortage * * * and rent increases. * * * [The bill] would seriously impair our Nation's ability to provide decent and affordable housing for low-income people.

3. Alternative Minimum Tax.—Section 501 of H.R. 3838 proposes that the Alternative Minimum Tax [AMT] should apply to the depreciation of real estate. According to the testimony, this would severely deter investment in multi-family housing.

Mr. Brenneman of the National Association of Realtors stated that the "AMT is so broad that it would render many of the regular tax investment incentives meaningless. * * * The 25-percent AMT is excessively high * * * considered with the broadening of the AMT base and the lowering of the top regular income tax rate to 38 percent." Mr. Poe, of the Mortgage Bankers Association, agreed that the AMT hinders investment. "This minimum tax on depreciation for real estate only aggravates an already adversely affected situation." Mr. Koelemij, Immediate Past President of the National Association of Home Builders, echoed their sentiments. "I have no quarrel with the purpose intended to be served by the minimum tax. * * * However, we are concerned that the House bill amounts to 'overkill' and would drastically undermine the incentive to invest in housing."

4. Interest Deduction Limitations.—Current law allows an individual to deduct up to $10,000 in interest on debts from the purchase or carrying of investment property. If interest paid exceeds the $10,000 limit, the deduction may carry over into future years' returns.

Section 402 of H.R. 3838 would limit all interest deductions to the total of net investment income plus $10,000 ($20,000 when taxpayers file jointly). While these limits would not apply to mortgage interest on principal and secondary residences, the limits would apply to interest paid on all other property or residences. (Some low-income housing would be exempt.)

The House Ways and Means Committee's rationale for this provision is that current law "excludes or mismeasures certain important sources of investment income." According to the testimony, however, the proposed change would stymie future investment in multi-family housing and endanger continued investment in currently owned properties due to the bill's retroactive effective date.

Mr. Koelemij observed, as did other witnesses, that "without the ability of the investor (in multi-family developments) to deduct all interest incurred on debt necessary to finance development, we are concerned that new construction of multi-family housing will suffer."

5. Itemized Deductions.—Current law allows taxpayers to itemize deductions on their tax return. The House Ways and Means Committee believes that itemizers receive a larger family size adjustment than nonitemizers by benefiting from medical and housing expenses and consumer interest deductions.

Section 132 of H.R. 3838 seeks to achieve more equity between itemizers and nonitemizers by placing a floor under itemized de-

ductions equal to $500 times the number of personal exemptions claimed. The presumption is that this change will simplify the tax system by reducing the number of itemizers by about one-third.

Witnesses testified that this provision would penalize homeowners and others who choose to itemize their deductions. Mr. Koelemij's reaction was that the "practical effect of this provision would provide homeowners with a personal exemption of $1,500 and non-itemizers with a personal exemption of $2,000 * * * [t]his provision would discriminate against homeowners and * * * indirectly discourage homeownership." The National Association of Realtors added,

> [I]ronically, the relative impact of this provision on [raising] homeownership costs is greater for low- and middle-income homeowners because it is an absolute dollar amount reduction as opposed to a percentage reduction. It is also severely biased against the family, since the amount disallowed increases with the number of family member exemptions. * * *

6. The At-Risk Rule.—Under current law, the at-risk limitation on losses from business and income-producing activities does not apply to investment in real estate in order to encourage such investment. For other types of investment, the at-risk rule limits deductions for losses to the amount the individual has "at-risk." The rule is designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment in an activity. The exception for investment in real estate is intended to encourage production of rental housing which is primarily financed with borrowed funds.

Section 401 of H.R. 3838 would extend the at-risk rule to real estate activities. The House Ways and Means Committee's intention by proposing the change was "to limit the opportunity for overvaluation of property (resulting in inflated deductions)." House Committee Report at 293.

While the House Ways and Means Committee's intentions were good, witnesses testified that the results would be disastrous to future investment in real estate, specifically, multi-family rental housing. According to Mr. Poe, "While the at-risk exception * * * would apply to a large number of financing transactions * * * any further limitation on this exception would have a drastic impact on the ability to raise equity to finance multi-family housing." Mr. Koelemij; added that, "The House bill seems to deny the at-risk exception in the case of ligitimate joint venture arrangements that do not involve potential overvaluation problems."

C. COMMUNITY DEVELOPMENT THROUGH TAX-EXEMPT FINANCING

A majority of the testimony at the hearing focused upon the impact of the tax-exempt provisions of H.R. 3838 on the ability of States, counties, cities and public authorities to finance projects that benefit the public through the issuance of tax-exempt securities. The witnesses concluded that the nominal Federal revenues ($3.8 billion over the next 5 years) generated by the changes provid-

ed in H.R. 3838 are not justified when compared to the adverse financial impact of these changes on State, county, and city governments.

The witnesses stressed that H.R. 3838 compounded the financial dilemma confronting most State and local governments as a result of the budget cuts required by the Gramm-Rudman Act. Due to reductions in Federal programs, local governments are faced with increasing responsibilities and are simultaneously confronted with a severe reduction in the resources available to meet these needs. The witnesses admonished the Committee that the changes contained in H.R. 3838 exacerbate the problems confronting State and local governments because they imperil their ability to finance projects that benefit the public through the issuance of tax-exempt bonds.

In testimony submitted to the Committee, Michael Hernandez, managing director of First Boston Corporation, explained how H.R. 3838 threatens the ability of State and local governments to finance public purpose projects:

> H.R. 3838 mounts a two-pronged attack on this bastion of State and local financing. First, the bill narrows the types of public purpose projects that may benefit from tax-exempt financing, and places stringent volume limitations on a multitude of previously unrestricted State and local borrowings. Second, the bill conditions the tax-free status of municipal obligations on compliance with a variety of new restrictions on the investment and expenditure of bond proceeds, and subjects income on certain municipal securities to alternative taxes, thereby eroding investor confidence that such obligations are or will remain tax-free, and increasing the cost to issuers of attracting bondholders.
>
> As a practical matter, the radical changes in the tax treatment of municipal obligations under H.R. 3838 would divide State and local financing into two categories: the unfeasible, and the more expensive.

1. Essential v. Nonessential Bonds.--Under current law, municipal obligations generally are tax-exempt unless more than 25 percent of the bond proceeds are used in the trade or business of a nonexempt entity and more than 25 percent of the principal or interest due on the borrowing is to be repaid from the revenues of such trade or business. H.R. 3838 alters the current tax treatment of tax-exempt bonds by deleting most historical bond descriptions and replacing them with new terminologies. The bill distinguishes initially between: (a) Essential Function Bonds [EFB]; and (b) Nonessential Function Bonds (NFB). In general, EFB's can be issued on a tax-exempt basis, subject to restrictions relating to arbitrage, arbitrage rebate, advance refunding and degree of nongovernmental use.

NFB's cannot be issued on a tax-exempt basis unless they constitute Qualified Nonessential Function Bonds [QNFB]. A NFB is any bond issued as a part of an issue if 10 percent (or lesser amount in certain cases) or more of the gross proceeds of the issue are to be used, directly or indirectly, in any trade or business carried on by

any person (other than a governmental unit) other than use as a member of the general public.

Certain NFB's can nevertheless be issued as tax-exempt bonds if they are included among the list of Qualified Nonessential Function Bonds and meet all of the standards and limitations of H.R. 3838 relating to those bonds.

H.R. 3838's distinction between nonessential and essential bonds was considered arbitrary and capricious. The witnesses concluded that the implementation of these distinctions would result in a perversion of public policy. They questioned the logic behind H.R. 3838's "nonessential" characterization of bonds issued to finance most of the facilities for the furnishing of water, multifamily rental housing, mass commuting facilities, sewage and waste treatment facilities, student loans, and bonds issued for the benefit of certain nonprofit institutions.

The distinctions between EFB's and NFB's were also criticized because they empowered the Federal Government, without any input from State or local governments, to define which of the bonds issued by states and localities are for essential purposes and which are nonessential. They concluded that such a distinction ignores the public policies that the current treatment of tax-exempt bonds was designed to promote.

The implausible consequences of the artificial distinctions created by H.R. 3838 were described by Senator D'Amato in his statement before the Committee:

> The burdens imposed on State and local governments by H.R. 3838 are not readily discernible. The bill attempts to disguise the real and detrimental impact it will have on projects financed through the issuance of tax-exempt bonds by describing them as either "nonessential" or "essential" function bonds. I cannot comprehend how a group of representatives and staffers in Washington can make such neat delineations and distinctions about which functions are essential or which are nonessential.
>
> In effect, the House of Representatives has decided that states and cities may sell all of the tax-exempt bonds they want for sewers but not for sewage treatment plants; for schools but not for student loans; for streets but not for subways. Moreover, H.R. 3838 requires that, however admirable the purpose of the bond issue, the issuer had better spend 5 percent of the funds within 30 days or else the bonds will be declared taxable. If taxpayers fail to perceive the logic behind these provisions, they should not be surprised, because there is none. I again fail to comprehend how this bill can be considered tax reform.

2. Volume Caps.—Under current law, the amount of tax-exempt bonds that States and localities may issue are generally not subject to statewide volume caps. However, under H.R. 3838, any portion over $1 million of any general obligation bond or traditional purpose revenue bond which is "used" by or "loaned" to other than a "natural person" must compete with nonessential purpose bonds for an allocation of a new statewide volume cap. The proposed statewide "volume cap" would place an absolute aggregate limit of

the greater of $200 million per State or $175/capita until 1987 and the greater of $125/capita or $200 million thereafter on "nonessential" purpose bonds (except bonds issued for airports, docks and wharves). These volume caps are allocated permanently among three purposes: (1) housing bonds; (2) charitable hospitals, nonpublic universities and other 501(c)(3) organizations; and (3) qualifying nonessential function bonds.

The hearing record is replete with statements contending that these limits are significantly below current volume levels and will sharply curtail the financing of critically needed infrastructure and other programs at precisely the time that more responsibility is being shifted to State and local governments.

From statements submitted to the Banking Committee, it appears that 501(c)(3) organizations, such as not-for-profit hospitals, would be most adversely affected by H.R. 3838. Several witnesses argued that H.R. 3838 failed to recognize that not-for-profit providers fill an important need within the nation's healthcare network.

The impact of H.R. 3838 on not-for-profit institutions was illustrated in a letter sent to Senator Garn by David Thompson, the director of the New York Hospital, a non-profit hospital. The hospital had planned to modernize its physical plant to meet current regulatory codes and standards. The estimated capital cost of this project is $395 million. The costs of modernization of this hospital alone would virtually equal the volume cap H.R. 3838 imposes on the State of New York. The hospital has already expended $1.5 million on this project. However, due to the volume cap, it faces an insurmountable obstacle to modernization because the hospital will be unable to meet the additional expense of taxable bonds.

The impact of the volume cap was described in testimony received from the firm of Mintz, Levin, Cohn, Ferris, Glovsky, and Popeo ("Mintz Levin"):

> Had this volume cap applied previously, over $5 billion of public purpose projects in 1984, and over $47.6 billion in 1985, would have been deprived of tax-exempt financing. The negative effect of the cap will vary by state and by type of project. Over 57 percent of the tax-exempt projects undertaken in Florida in 1984 no longer would be eligible under H.R. 3838; equally precipitous reductions from 1984 levels would occur in other states, such as Alaska (48 percent), California (42 percent), Colorado (29 percent), Louisiana (28 percent), Massachusetts (22 percent), Minnesota (30 percent), North Dakota (38 percent), Nebraska (27 percent), New Jersey (16 percent), Nevada (46 percent), Pennsylvania (28 percent), Rhode Island (64 percent), South Dakota (30 percent), Texas (38 percent), Utah (45 percent), and Virginia (28 percent). The corresponding percentage of 1985 projects that would not have obtained tax-exempt financing is even higher.
>
> The cost of taxable borrowing historically has been approximately 30 percent higher than that of comparable-term tax-exempt debt. Thus, the likelihood is that the vast majority of projects shut off from tax-exempt financing by H.R. 3838, either because they fall into a prohibited cate-

gory or because they fail to obtain an allocation under the new volume cap, will be priced out of the reach of many state and local communities.

3. The Application of the Alternative Minimum Tax to Previously Tax-Exempt Bonds.—Section 57(a)(6) of H.R. 3838 provides that interest earned on tax-exempt nonessential function bonds issued after December 31, 1985, be treated as a preference item for purposes of computing the Alternative Minimum Tax [AMT] base for both individuals and corporations.

The nonessential function bonds (see secs. 141 and 142, H.R. 3838) which would be subject to the AMT include bonds which finance some of the most essential and expensive local services. States, counties, cities and other municipal entities represent a separate and parallel form of government oriented to providing local services not provided by the Federal Government. The testimony presented to the Committee described the extraordinary range of these services that included, among others, sewage treatment plants, mass transportation facilities, student loans and hospitals. The witnesses observed that local governments undertake these services after detailed study and debate, careful planning, and disciplined execution. The municipal market provides a link between the local government process and the pools of private capital which finance that level of government. The testimony revealed that the local population pays for these services and, as a consequence, their cost is very important. The costs attendant to the provision of these services directly affect the taxes or user charges that will be required to support them.

The witnesses agreed with the House Ways and Means Committee report language to the extent that the AMT should serve "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits." House Committee Report at 305–06. However, the witnesses were in general disagreement with the application of AMT to non-essential purpose tax-exempt bonds. They claimed that the logic behind the AMT does not apply to tax-exempt bonds because such bonds provide investors with income but generate absolutely no tax shelter.

The witnesses also disparaged the justification of the application of the AMT to tax-exempt bonds contained in the Ways and Means Committee report. The report states that income from nonessential function bonds "must be added to the minimum tax base if the minimum tax is to serve its intended purpose of requiring taxpayers with substantial economic income to pay some tax." House Committee Report at 307. The witnesses noted that this was a new rationale for the AMT and admonished the Senate to scrutinize this rationale prior to its acceptance.

In statements submitted to the Committee, witnesses argued that investors do not use tax-exempt bonds to avoid tax liability. The remarks of Richard Franke, chairman of the Municipal Finance Industry Association, are representative of the testimony the Committee received on this subject:

> They invest after-tax dollars in a municipal instrument after examining the broad spectrum of fixed income in-

vestment alternatives which the free market offers. Municipal bonds are suitable investments for many taxpayers, with the added social bonus of financing public and quasi-public projects. By contrast, the taxpayer who uses tax preferences to reduce before-tax income to the point that the AMT becomes relevant is not a candidate for municipal bonds. If one has successfully sheltered his income, he will have reduced his tax bracket to a level that decreases the value of an investment in lower yielding tax-exempt bonds. The Senate should keep this critical distinction in focus.

AMT will unfairly stigmatize and complicate the market for this investment alternative.

4. Arbitrage and Rebate.—a. Arbitrage.—Under section 147 of H.R. 3838, certain well-established rules relating to arbitrage are repealed and new rules are established. The rationale for the new provisions that limit the ability of states and localities to engage in arbitrage activities is that arbitrage is an inefficient substitute for additional bond volume and can be more costly to the Federal Government than additional volume.

Under current law, borrowers are provided with a 3-year period in which the proceeds of borrowings can be invested pending staged disbursement during construction. Current law also requires that investment earnings during this period be considered in the amount of bonds to be issued to finance a project. Such investment earnings are often retained, thereby reducing the amount required to be financed.

By contrast, H.R. 3838 requires that proceeds to acquire tangible property (land, equipment or vehicles) can be invested at a higher yield for no more than 30 days and construction proceeds can be invested at a higher yield for periods to be determined by a complex set of new rules. Moreover, even if there is compliance with the arbitrage rules, section 147(e) imposes a direct tax at the rate of 100 percent on all investment earnings on certain funds of the issuer to the extent that these earnings exceed the yield on certain applicable bonds. H.R. 3838 treats a bond as a taxable "arbitrage" bond (retroactively to the date of its issue) unless, (a) all investment earnings on bond proceeds over and above the yield on the bonds, and all earnings on the excess, and (b) all earnings on the debt service funds (over $100,000 per year) even though the debt service fund is derived from outside sources such as sales tax revenues, are paid to the U.S. Treasury not less frequently than once every 5 years and no later than 30 days after the maturity or redemption of the bonds.

The witnesses comments on these provisions were uniformly negative. They suggested that H.R. 3838 ignores the manner in which major projects are financed. The misunderstanding of the economic realities confronting State and local governments during the construction of projects contained in H.R. 3838 were articulated by Mayor Xavier Suarez of Miami, FL: "[P]rojects do not [always] proceed on schedule and all bonds cannot be sold at the moment proceeds can be put to use. Moreover, in most cases, arbitrage profits are reinvested which reduces the total revenue of bond issuance

and the tax loss to the Federal Government." Mayor Suarez believed that the use of arbitrage revenues in this fashion can hardly be characterized as abusive. Although he and other witnesses acknowledged that any abusive usage of the current arbitrage rules should be remedied, they expressed concern that section 147 did not represent a realistic approach.

b. Rebate.—The rebate provisions of H.R. 3838 also received much critical comment from the witnesses. These provisions add complicated substantive and procedural rules regarding the investment of all bond-related funds. Violation of these rules could make any bond issue retroactively taxable to the date of issuance. Therefore, uncontrollable events delaying expenditure for bond proceeds would mean non-compliance "in fact," and retroactively the bonds would become taxable.

The direct economic consequences of H.R. 3838's rebate requirements upon States and localities were best articulated in the statement submitted to the Committee by the firm of Mintz Levin:

> The unprecedented application of this morass of restrictions to all State and local issuers would impose at least three layers of additional cost on the use of municipal bonds as a financing tool. First, the rebate requirement * * * would terminate the ability of government issuers to defray projects costs * * * Second, States and localities would have to shoulder the significant administrative costs of continually monitoring the yield on their investments and of putting in place a rebating mechanism. Third, the spectre of retroactive taxation of interest on municipal securities if an issuer is unable to comply with each of a host of difficult new requirements will undermine investor confidence in the tax-exempt status of such income.

5. The 30-Day Expenditure Requirement.—The rationale behind Section 149(e) of H.R. 3838 was another which eluded the witnesses before the Committee. This section provides that any bond is taxable retroactively unless: (a) 5 percent or more of the net proceeds of the issue are spent to perform the governmental purpose within 30 days after the date of delivery; and (b) all of the net proceeds are spent within 3 years after the date of delivery.

The witnesses could not identify any public policies promoted by this provision. The havoc it would wreck upon State and local governments was vividly demonstrated during the hearings by the dilemma confronting the State of Georgia. Georgia has been unable to float a bond issue due to the requirement that 5 percent of the proceeds of a bond issue be spent within 30 days of issuance. The State's constitution requires that proceeds of a bond issue be in hand prior to signing contracts to spend the money raised by that bond issue. Consequently, due to the contradictory requirements of the State constitution and the House bill, bond issuances have been postponed.

6. Advanced Refunding.—Section 149(d) prohibits the advance refunding of nonessential function bonds. In addition, H.R. 3838 imposes many restrictions on essential bond refundings. The witnesses contended that these provisions impose arbitrary limitations on the number of times (2) a borrower can refinance debt and dic-

tates limitations on the structure of the refunding bonds. Refundings are necessary and should not be discouraged because they save local governments interest and other costs. The witnesses noted that the elimination of advanced refunding limits the ability of issuers to stay current in a period of falling interest rates and impairs the ability of institutions to eliminate covenants that become outdated or unworkable. These limitations imposed by H.R. 3838 will increase the cost of financing public projects and these costs would ultimately be borne by the taxpayers of the affected States and localities.

7. Investors.—a. Individuals.—At this time, individuals comprise the largest segment of the market for tax-exempt bonds. Over the past decade individuals have represented the largest single source of capital for municipalities, mostly through participation in municipal bond trusts and funds. The advent of bond trusts and funds have opened up the municipal bond market to small investors.

H.R. 3838 includes nonessential function bonds as one of the tax preference items utilized in calculating the 25-percent minimum tax on individuals. The witnesses testified that the alternative minimum tax provisions of H.R. 3838 imperiled individual participation in the tax-exempt securities markets because: (1) the taxation of heretofore tax-exempt income would dramatically reduce investor interest in these bonds, and (2) the elimination of the significant demand represented by individual investors in the bond market would drive up the cost of all nonessential function bonds. Richard Kezer, representing the Public Securities Association (PSA), acknowledged that the application of the alternative minimum tax to individuals would "at best (result in) higher costs for projects like solid waste disposal and low-income housing, and quite possibly, the elimination of projects rendered infeasible by higher financing costs."

b. Commercial Banks.—Current law disallows 20 percent of a financial institution's deduction for interest on indebtedness incurred to purchase or carry obligations which are exempt from federal tax.

Section 802 of H.R. 3838 increases this disallowance to 100 percent for all bonds acquired after January 1, 1986. It adds a temporary "small issue" exemption. The "small issue" exemption applies to public purpose bond issues of $3 million or less, and expires in 3 years. Two reasons are given for the proposed change: first, the present rules discriminate in favor of financial institutions at the expense of other taxpayers; and second, financial institutions may drastically reduce their tax liability by investing in tax-exempt obligations.

Commercial banks represent about 30 percent of the market in the tax-exempt securities and concentrate their purchases on bonds with maturities of up to 10 years. The witnesses feared that section 802 of H.R. 3838 would drive commercial banks from the tax-exempt markets. B. F. Backlund, representing the Independent Bankers Association testified that:

> Tax-exempt bonds are vital to municipalities, which market a large percentage of their bonds to commercial banks. Denying the tax-exempt status of bonds held by

banks will undoubtedly reduce banks' participation in this market. If that happens, yields on tax-exempts will rise, causing municipalities' cost of financing public projects to increase substantially.

The conclusion reached by the witnesses was that the elimination of commercial banks from the market for tax-exempt bonds would have the most detrimental impact on small and intermediate sized municipalities—the governments least able to tolerate the financial trauma. The witnesses testified that while sophisticated and larger issuers might find a public market for their more substantial issuances, small and intermediate size municipalities might be unable to find a market at all.

Finally, commercial banks are seriously concerned with the retroactive application of a 100 percent disallowance to existing portfolios of tax-exempt obligations. H.R. 3838 would apply to all tax-exempt bonds "acquired after" January 1, 1986—rather than to bonds "issued after" that date. Financial institutions strongly urged modification of the language to affect only bonds "issued after" the effective date chosen. Otherwise, existing portfolios, where purchases were predicated on the expectation of a 20 percent disallowance, would be severely jeopardized. Witnesses insisted that it is only fair that bond purchasers be able to rely on the tax consequences existing at the time of purchase. This retroactive change would be particularly detrimental to a troubled institution whose bond portfolio's liquidity would be seriously impaired by the retroactive tax change.

c. Property and Casualty Insurance Companies.—Under current law, property and casualty insurance companies are permitted to deduct reserves for losses that have been incurred but not paid. As a result, property and casualty insurance companies are cyclical purchasers of municipal bonds. Therefore, when this industry is experiencing a period without excessive underwriting losses, it is an important source of capital for municipal borrowers. Richard Kezer, testifying on behalf of the PSA noted that property and casualty insurers are at a point in their business cycle where they are ready to return to the tax-exempt bond market after a "particularly long hiatus."

However, Mr. Kezer and others testified that section 1022 of H.R. 3838 threatens to drive these purchasers from the market place. Section 1022 was designed to reduce the deductible portion of the loan loss reserves by a portion of the tax-exempt income earned by these companies since a portion of the loss reserves may be funded out of tax-exempt income. William Holby, representing the National Association of Bond Lawyers, estimated that the implementation of this provision would effectively result in the imposition of a 3.6-percent tax on otherwise tax-exempt interest prior to 1988, and a 5.4-percent tax on such income thereafter.

The witnesses feared that the application of a special alternative minimum tax to these companies also would discourage investments in tax-exempt bonds. Section 1023 of H.R. 3838 provides that beginning in 1988, the taxable income of such companies shall be equal to the greater of its regular taxable income or $^{20}/_{36}$ths of its net gain from operations. Income on all tax-exempt bonds acquired

after November 15, 1985, would be included in the net gain from operations. For companies subject to this alternative minimum tax, income on municipal obligations would be taxed at the same 20-percent rate as income from all other sources.

The witnesses argued that the operation of sections 1022 and 1023 would tend to remove property and casualty insurance companies from the intermediate and long-term markets. As in the case of commercial banks, the elimination of these investors would cause the yield on these bonds to increase and taxpayers would ultimately have to bear the costs attendant to these increases.

D. THE INTERNATIONAL COMPETITIVENESS OF U.S. FINANCIAL AND MANUFACTURING INSTITUTIONS

During the 2 days of hearings, a number of witnesses testified about the effect of H.R. 3838 on the competitiveness of U.S. institutions. Part of this testimony focused on the much-discussed provisions that repeal the investment tax credit and the accelerated cost recovery system. The witnesses testified here, as they have also done before other Congressional committees, that these provisions will cripple the incentives of U.S. manufacturing firms to invest in plant and equipment. Without adequate capital formation, the United States will suffer as an international competitor, and its basic, strategic industries will also be threatened.

The other relevant testimony focused on the provisions of H.R. 3838 affecting the financing of foreign trade, the most important of which are the changes to the foreign tax credit and the repeal of the ability to defer tax on foreign income. The witnesses testified that, taken together, these provisions would not only affect the ability of U.S. financial institutions to compete in foreign markets; they would also impair the ability of U.S. exporters to obtain adequate financing for the sale of goods abroad.

1. Repeal of Accelerated Cost Recovery.—As discussed above, the Accelerated Cost Recovery System [ACRS] of current law permits the accelerated recovery of the cost of capital assets through depreciation deductions over a predetermined recovery period that is generally shorter than the asset's useful life. In addition, an investment tax credit (ITC) is allowed for 10 percent of investment in certain kinds of capital assets.

Title I of H.R. 3838 would repeal both ACRS and the investment tax credit, which would reduce and spread out the writeoffs for capital assets over their useful lives. The stated reasons for these changes are: (1) current law allegedly creates significant inequities in the tax system because taxpayers with considerable income can escape all taxation through use of ACRS and the ITC, while taxpayers with less income may not be helped; (2) the evidence is conflicting about whether the provisions have stimulated investment or economic growth; and (3) the greatest stimulus to growth arises from lower overall tax rates and removal of excessive government incentives for certain types of activity that skew private decision-making.

Witnesses from the manufacturing industry argued that, in the present competitive environment, continued investment in plant and equipment is essential to future U.S. competitiveness. H.R.

3838 will make capital investment more costly at a time when U.S. firms, especially manufacturers, are facing an unprecedented challenge from abroad. The industry representatives argued that this anti-capital bias would be devastating and would not be offset by the proposed 10 percent corporate rate reduction.

The manufacturers directly challenged the assumptions underlying H.R. 3838, especially the notion that accelerated cost recovery does not promote capital formation. According to James Mack of the National Machine Tool Builders Association:

> History has shown that investment spending is highly responsive to changes in the investment tax credit. The restitution of the ITC in 1971, followed by the 1975 increase from 7 to 10 percent, have raised the capital equipment share of GNP to the highest levels of the past half-century.

Paul Huard of the National Association of Manufacturers enumerated the negative effects of increased capital costs on the U.S. economy:

> A long-run economic analysis of H.R. 3838 implies a 2.0 percent reduction in the level of real GNP. This results in a permanent addition to the federal deficit, when measured as a proportion of GNP, of 0.5 percentage points.

The argument that the proposed changes in H.R. 3838 would have a depressing effect on capital formation and U.S. economic growth has been the subject of detailed discussion elsewhere, and is one of the principal complaints of the U.S. manufacturing industry with H.R. 3838. The comments to the Banking Committee emphasized that these adverse developments would also be reflected in a loss of international competitiveness. As Mr. Huard pointed out:

> The competitive position of the United States deteriorates sharply under H.R. 3838. The increased taxes on U.S. manufacturing are reflected in higher prices for U.S. goods relative to those of foreign competitors. The reductions in the cost of capital for inventories at the wholesale and retail levels do not aid U.S. goods vis-a-vis imports because the improved treatment generally extends to foreign goods sold here as well.

Mr. Mack noted the particular competitive challenges facing the machine tool industry due to extensive global competition and integration of computer technology into metalworking equipment. He noted the assessment of the International Trade Commission that foreign competitors to the U.S. machine tool industry have appreciably greater access to capital than U.S. firms. Capital access is vital to an industry in which the useful life of the equipment is increasingly tied to the state-of-the-art of the computer. Given rapid advances in computer technology, the declining useful life of programmable controls running the machine tools hastens technological obsolescence for the overall equipment.

Mr. Mack added that machine tool export performance has dropped precipitously, from more than $1 billion in 1981 to $400 million in 1985. He argued that this has an even broader effect for

U.S. competitiveness because machine tools are such an integral part of American manufacturing and defense industries:

> The loss of America's machine tool building capability could well signal the beginning of the decline for all of America's metalworking manufacturing industries.

Finally, Robert Hostetler, President and CEO of CTS Corp., representing the Electronic Industries Association, argued that H.R. 3838 will exacerbate a growing negative balance of trade in electronics—an export-oriented industry with $29 billion of exports in 1985. Despite these levels, they represent a declining share of world trade for these products. Already at a competitive disadvantage internationally, U.S. industry would be devastated by a tax code that took an anti-capital bias, when more favorable capital formation conditions exist for foreign companies.

2. Impediments to International Competitiveness of U.S. Financial Institutions and U.S. Exports in Foreign Markets.—Under current law, the U.S. taxes U.S. citizens, corporations and residents on their worldwide income, including their foreign income. At the same time, the rules applied to income earned abroad recognize the primary right of the country in which income is earned to tax that income. To prevent double taxation of U.S. taxpayers on their foreign income—once by the foreign country in which the income is earned, and again by the United States—a foreign tax credit is applied to reduce the U.S. tax on foreign income by the foreign income tax paid. A foreign credit is allowed for foreign taxes paid on income derived from (1) direct operations, (2) passive investments, and (3) dividends received from foreign subsidiary corporations operating in foreign countries and paying foreign taxes.

Income from operations of foreign subsidiary corporations is also treated differently than income from direct overseas operations by U.S. taxpayers. The U.S. tax is deferred until dividends on that activity are actually paid into the United States. Changes proposed in these areas are of major concern to U.S. banks and service industries, the U.S. companies they serve overseas, and foreign banks with subsidiaries in the United States.

a. Reduction in Foreign Tax Credit.—Under current law, a foreign tax credit is available to U.S. taxpayers for overall taxes paid abroad on foreign income. The credit is subject to the limitation that it not reduce U.S. taxpayers' U.S. tax on U.S. income, thereby recognizing primary U.S. authority to tax domestic income. Only U.S. tax on foreign income is affected. The limitation is generally defined as the fraction of U.S. tax on worldwide income represented by the ratio of the taxpayer's foreign taxable income to worldwide taxable income. Subject to that limitation, the overall method of determining the credit permits crediting of high foreign taxes on one category of income in high-tax countries against income categories in low-taxes countries. In effect, it permits an offset of taxes, and applies a single tax rule to all foreign income. For example, for U.S. banks, 50 foreign governments impose withholding taxes at varying levels on interest payments made to lenders outside the country, but current rules permit averaging of taxes paid across countries.

Under section 602 of H.R. 3838, the ability to average foreign tax rates for foreign tax limitation purposes would be eliminated for banks and certain other companies. For example, for banks, the foreign tax credit for withholding tax imposed on a transaction could not exceed the level of U.S. tax on the net interest income of such loans. Thus, for "cross-border lending," where a U.S. bank lends directly from the United States to a borrower in another country, foreign withholding taxes in excess of U.S. tax on the foreign loan could not be credited against U.S. taxes on other income in that country or on other foreign-source income. The House Ways and Means Committee offered the following justification for this change:

> The Committee believes that, in some cases, the present ability of U.S. persons to average foreign tax rates for foreign tax credit limitation purposes and thereby reduce or eliminate the residual U.S. tax on their foreign income has undesirable consequences. Under present law, U.S. taxpayers with excess foreign tax credits have an incentive at the margin to place new investments abroad rather than in the United States when the income that those investments will generate will be taxed abroad below the U.S. rate.

House Committee Report at 333 the report indicates that this trend may be exacerbated as U.S. tax rates fall, creating more excess tax credits in foreign countries. The report also cites categories of income of particular concern, especially banking, insurance, and shipping, where income earned is relatively movable or is subject to low rates of foreign taxation. Therefore, passive income, banking, insurance and shipping income would be subjected to separate foreign tax limitations.

The National Foreign Trade Council and the Bankers Association of Foreign Trade, organizations that include some of the Nation's largest banking institutions involved in international finance and trade, expressed strong opposition to the proposed change. They argued that the new provisions would seriously and adversely affect U.S. export financing to major U.S. markets, which would directly damage the U.S. domestic economy. The change would similarly reduce the incentive to lend to developing countries, many of which are in need of continued access to foreign capital, thus limiting their chances of recovering as major U.S. export markets.

Responding to the argument that current decisions to lend abroad are based on the search for tax credits, the testimony emphasized that the decision to lend depends much more heavily on the needs of their U.S. clients, as well as on market conditions, and the terms and soundness of particular loans.

In his testimony before the Committee, the president of the American Bankers Association discussed the likely competitive effects of limitations on cross-border lending:

> Foreign lending has become increasingly competitive in recent years. Any additional tax might force U.S. banks out of many overseas markets. Foreign lending by U.S. banks supports U.S. trade. Our manufacturing and service industries rely heavily on U.S. banks to finance the goods

and services that they export as well as their foreign operations. Because of the role foreign loans by U.S. banks play in financing the sales of U.S. commodities, products and services abroad, a reduction in the competitiveness of U.S. banks would have an adverse impact on U.S. trade, our balance of payments, and even on domestic employment. If American banks were replaced by foreign banks, these banks would work to replace U.S. goods and services with those from their own countries.

The witnesses also identified several problems with the foreign tax credit rules set forth in H.R. 3838. First, the rules violate the tax reform goal of "economic neutrality" by penalizing loans to countries with gross withholding taxes.

Second, while taxation systems vary by country, the United States foreign tax credit for withholding taxes is comparable to the tax treatment used by our major export competitor countries—Japan, the United Kingdom, and major exporting countries in Continental Europe.

Third, the proposal would harm the U.S. balance of payments and therefore adversely affect domestic employment. In this respect, one witness estimated that a reduced foreign tax credit will most seriously harm the export of capital goods, which now account for 50 percent of total U.S. exports. If the tax laws prevent U.S. banks from competitively financing domestic goods for export, the production of those goods—and jobs—will move outside the country.

Fourth, all the witnesses commented that the tax credit reduction directly undercuts administration efforts, announced by U.S. Treasury Secretary Baker in October, to encourage increased lending by U.S. commercial banks to less developed countries. Under the so-called "Baker initiative" all commercial banks are being asked to increase their lending exposure to 15 major debtor countries by $20 billion over 3 years. Present exposure to these countries is $272 billion, of which $91 billion, or one-third, is in U.S. bank loans. The new bank loans are intended to support these countries' efforts at fundamental economic reform so that they can resume growing, return to full creditworthiness, and service new and existing bank loans. Walter Shipley, chairman and CEO of Chemical Bank speaking for the New York Clearing House Association, noted that the vast majority of foreign gross withholding tax incurred by U.S. banks is paid to less developed countries including major debtor countries. H.R. 3838 would have an adverse impact on the profitability of new and existing loans (even with limited transition rules on interest accrued before 1989) going to the target countries under the Baker plan. He argued that the present rule shoud be retained so that banks can continue making necessary loans.

As Mr. Shipley, and other witnesses pointed out, the proposed change is discriminatory because it strikes narrowly at banks, "it would apply to only one form of foreign tax (gross withholding) imposed by only one kind of income (interest) realized by only one group of U.S. taxpayers (financial institutions)."

b. Repeal of Deferral of Tax Payable on Foreign Income.—Under current law, foreign-source income earned by U.S. corporations engaged in foreign operations through a foreign subsidiary are subject to foreign tax, but not subject to current U.S. tax. U.S. tax on this income is deferred until the foreign corporation pays dividends into the United States. Current tax treatment supports the competitive position of U.S. service industries operating overseas. According to the testimony, all industrialized countries recognize deferral for overseas active business income, and a change in U.S. tax law would reduce the competitive position and growth potential of U.S. service industries.

Section 621 of H.R. 3838 would repeal this deferral for certain types of active business income, including banking and insurance income, making them subject to current U.S. tax. The stated purpose of the change is to prevent manipulation of U.S. companies' operations and investments for avoidance of tax. Eliminating U.S. tax benefits is intended to place U.S. and foreign investment decisions on a more even footing and encourage more efficient use of capital.

This proposed change generated strong opposition by associations representing major U.S. banks involved in international finance. They argued that the repeal of deferral would add to the costs of doing business internationally and place U.S. based firms at a competitive disadvantage. The deferral provision encourages firms to retain capital for investment which permits growth of their foreign subsidiary. Loss of deferral would limit the flexibility of U.S. banks and service corporations to expand operations abroad to market U.S. goods and services, and would thereby worsen the U.S. trade and current account positions. It is also discriminatory against banks and service corporations. Witnesses testified that the disadvantage the United States would impose on its own firms would be tantamount to denying U.S. banks the national treatment, or equal competitive position with foreign banks, that we aggressively seek in bilateral negotiations.

In his statement to the Committee, Walter Shipley emphasized the anti-competitive nature of the proposed change:

> The foreign subsidiary income provision of the House bill should be rejected because it would impose competitive disadvantage on foreign subsidiaries of U.S. banks. No other home country of major international banking institutions imposes such a tax, nor does the United States tax the active, operating income of foreign subsidiaries of other U.S. companies on a current basis. U.S. banks are often required by U.S. or foreign laws to do business in foreign countries through foreign subsidiaries.

In sum, the testimony revealed that the repeal of deferral would adversely affect the U.S. international competitive position in two ways. By reducing the ability of U.S. providers of banking and other services to compete abroad, their direct contribution to the U.S. current account position would be reduced. In addition, U.S. exporters would face a loss of trade and export credit services from U.S. owned banks, thereby increasing the difficulty of competing for world export markets.

E. OTHER PROVISIONS

Apart from the categories mentioned above, certain other provisions of H.R. 3838 were addressed by witnesses from the financial community. These include the following:

1. Branch Level Tax.—Under current law, a U.S. branch of a foreign bank sometimes pays no withholding tax on dividends paid to a foreign head office, while a U.S. subsidiary of a foreign bank always pays withholding tax on dividends paid to its foreign parent. Section 651 of H.R. 3838 seeks to change this disparate treatment by replacing the "second withholding tax" of current law with a branch-level tax on certain U.S. branch income of foreign corporations. The Institute of Foreign Bankers testified that this new provision, (1) rather than establishing an equivalent tax method, actually discriminates against foreign banks by imposing more tax at the corporate level than is currently imposed on U.S. banks, and (2) creates a conflict with U.S. treaty obligations.

2. Puerto Rico Banks and Savings Institutions.—These organizations testified that section 841(b) of H.R. 3838 would change the conditions under which "Section 936" corporations would receive favorable tax benefits, and that this change would stimulate a drain of capital from Puerto Rican financial institutions. They also testified that section 612(a)(1) of H.R. 3838 would change the foreign-source income rules so as to detract from the ability of Puerto Rican thrift institutions to attract investments from these Section 936 corporations, which in turn would raise the cost of housing finance.

3. Nonbank Financial Services Companies.—For the same reasons as banks (discussed above), these institutions oppose H.R. 3838's proposed repeal of the reserve method of accounting for bad debt deduction. Likewise, they oppose the proposed repeal of the provisions permitting tax-free reorganizations of troubled thrifts, on the grounds that these have effectively limited "the number of defaults, with their potential cost to the FSLIC and the loss of depositor confidence * * * [such reorganizations] are undoubtedly cost effective to the FSLIC and the U.S. Treasury as a whole." Finally, they object to the unfairness of the bill's failure to include financial service companies with banks and savings institutions in an exception to the "single corporation" rule for application of the foreign tax credit.

ADDITIONAL VIEWS OF SENATORS D'AMATO, MATTINGLY, HECHT, AND RIEGLE ON LOAN LOSS RESERVES

The report of the Banking Committee requires augmentation with respect to several issues. Specifically, we have grave reservations concerning H.R. 3838's treatment of the loan loss reserves of commercial banks. The importance of this issue to the safety and soundness of the banking industry requires the Banking Committee to alert our colleagues to the adverse impact of these provisions upon the banking industry. H.R. 3838's treatment of loan loss reserves does more than merely increase the Federal incomes taxes paid by commercial banks. At a time when many commercial banks have been placed in a precarious financial posture due to agricultural, foreign, and domestic oil industry loans, we should be looking for ways to encourage them, increase loan loss reserves rather than penalizing them for doing so.

Legislative proposals should be judged on the basis of the purposes those proposals are intended to accomplish. The Ways and Means Committee Report on H.R. 3838 contained several justifications for the repeal of the loan loss reserve deduction for larger banks: (1) "* * * use of the reserve method for determining losses from bad debts results in deductions being taken for tax purposes that statistically occur in the future," (2) "* * * use of the reserve method allows deductions prior to the time that the losses actually occur;" and (3) "* * * many banks, particularly those who are members of large banking organizations, have used the reserve method for determining losses from bad debts to lower substantially their federal income tax liabilities."

The Banking Committee received testimony from witnesses familiar with the banking business that contradicts the arguments offered in the House Report concerning the repeal of the loan loss reserve deduction. The testimony demonstrated that loan loss reserves reflect current, but largely unidentifiable, losses in a bank's loan portfolio. Further, the actual charge-off of a bad loan is often postponed far beyond the moment at which it ceases to produce income. The delay in charging off the loan until long after it is identified as a bad loan is attributable in many cases to protracted attempts to work out the loan and in other cases to legal and regulatory proceedings.

The third argument against H.R. 3838's treatment of the loan loss reserve deduction relates largely to issues addressed in the Tax Reform Act of 1969. Prior to the enactment of that legislation, Treasury Department rulings permitted banks to deduct for tax purposes up to 2.4 percent of loans without regard to the reserves maintained for book purposes. The 2.4 percent figure had been set so that all banks would be able to maintain a reserve large enough to protect against catastrophic losses. While this may be a worthwhile public policy decision, it did result in an artifically high tax

deduction. The Tax Reform Act of 1969 repealed this rule but gave banks 18 years to phase out the percentage method.

The changes made in 1969 have had their intended effect. The loan loss reserve deduction now is less than the actual loss reserve as reported to shareholders and bank regulators. Today, the tax code limitations on the loan loss reserve deduction result in an overpayment of taxes as a bank is prevented from recognizing its actual economic losses.

We consider these to be compelling arguments against H.R. 3838's denial of the loan loss reserve deduction. Therefore, we urge our colleagues to reconsider this issue when it is taken up in the Finance Committee or in the full Senate.

The maintenance of adequate loan loss reserves is one of the more significant expenses of conducting a banking business and it should be recognized as such by federal income tax law. In addition, bank regulators, bank auditors, financial analysts and others rely upon bank loan loss reserves in assessing the adequacy of capital and in evaluating whether earnings are being fairly and correctly reported. Failure to give tax recognition to loan loss reserves maintained by banks for regulatory and financial reporting ignores the economic realities confronting banks and the amount of taxes that they currently pay. Under current regulatory rules, these prepayments must be charged against earnings, and therefore against capital, under certain circumstances. The repeal of the loan loss reserve deduction will have a direct, adverse impact on bank capital. Furthermore, this adverse impact would come at a time when major sectoral weaknesses in such areas as farming, real estate, energy and export finance, are putting stress on the banking system. The proposed recapture of outstanding tax reserve balances over a 5-year period would worsen this situation in most instances. Indirectly, repeal of the loan loss reserve deduction may influence bank management to some extent in setting additions to reserves for loan losses.

We urge our colleagues to preserve the principle of the loan loss reserve deduction for commercial banks without regard to the asset size of the institution. Further, we urge them, particularly if there is concern about the use of loan loss reserves to reduce artificially Federal income tax liability, to provide for the determination of the amount of the deduction by reference to the amount of the reserve maintained for book purposes, even if such book/tax conformity has to be attained over a period of years.

ALFONSE M. D'AMATO.
MACK MATTINGLY.
CHIC HECHT.
DONALD W. RIEGLE, Jr.

ADDITIONAL VIEWS OF SENATORS D'AMATO, MATTINGLY HECHT, GRAMM, DODD AND SASSER ON TAX-EXEMPT FINANCING

GENERAL COMMENTS

Although the Committee Report provides an excellent synopsis of the testimony that the Banking Committee received on the adverse effects of H.R. 3838 on tax-exempt financing, the Report does not contain any recommendations to our colleagues regarding possible alternatives to the provisions of Title VII of H.R. 3838. We do not presume to intrude upon the jurisdiction of the Senate Finance Committee by making the observations contained in these views. Rather, we intend to convey formally our concerns regarding the disruptive and extremely negative impact on the capital markets for state and local governments that will result, and to a certain extent has already resulted from, many of the provisions of H.R. 3838 that affect tax-exempt financing.

Rather than recite a litany of the potential adverse effects of Title VII of H.R. 3838, we believe that the Senate Finance Committee should address several fundamental issues when drafting legislation affecting the tax-exempt status of state and local bonds. First, a determination must be made whether the revenues that the Treasury will gain from H.R. 3838 justify the increased costs to state and local governments certain to result from the removal of tax-exempt status of a significant amount of bonds. The evidence presented to the Banking Committee demonstrated that the increases in costs to state and local governments will be grossly disproportionate to the projected federal income tax revenues. The increased cost of financing public purpose projects that state and local governments will incur due to H.R. 3838's treatment of tax-exempt bonds will ultimately be borne by state and local taxpayers who will have to pay increased sales or property taxes. Thus, while H.R. 3838 alleviates the tax burdens on individuals, these benefits may prove illusory. H.R. 3838 merely shifts the tax burden rather than alleviates it since the cost of financing public purpose projects will be raised through Title VII's restrictions, and these costs will be borne by state and local taxpayers.

Second, the increasing shift of responsibility for the provision of public services from the federal to the state and local level will not be facilitated by the restraints on infrastructure financing contained in H.R. 3838. At a time when Congress has restricted the amount of federal funds available to state and local governments through a combination of the budget cuts mandated by the Gramm-Rudman-Hollings Act (Gramm-Rudman) and reductions in revenue sharing programs, H.R. 3838 severely impairs the ability of state and local governments to raise funds to finance public purpose projects and community services. We urge our colleagues to

consider the severe financial pressures confronting our colleagues to consider the severe financial pressures confronting our colleagues in state and local governments and the manner in which H.R. 3838 impairs their ability to finance and provide public services.

Third, in addition to increasing the costs of raising capital, Title VII of H.R. 3838 violates fundamental notions of federalism by curtailing the power of state and local governments. H.R. 3838 assaults the doctrine of reciprocal immunity by imposing complex and costly record keeping requirements on issuers and conditioning tax-exempt status upon requirements which are often beyond an issuer's control and which certain issuers are unable to comply due to prohibitions in their state constitutions.

Fourth, the effective date of January 1, 1986, has wreacked demonstrable havoc in the tax-exempt market. Local governments have had to cease work on a wide range of important projects and programs or proceed under extremely confused and complicated conditions. The markets for new municipal securities are nearly inactive despite the historically low interest rates currently available. The retroactive effective date has contributed significantly to the overall atmosphere of unfairness and inter-governmental inequity surrounding the bill. Changes of this type and magnitude, if enacted at all, should not be effective before the enactment of a bill embodying the consensus of both legislative chambers. However, the effective date controversy should not be allowed to mask the substantive problems with the bill.

Finally, any tax bill considered at this time should not make broad, restrictive changes in the field of municipal finance such as those contained in H.R. 3838. The implementation of H.R. 3838's tax-exempt bond provisions may be premature in light of the recent enactment of the Tax Equity and Fiscal Responsibility Act (TEFRA) and the Deficit Reduction Act (DFA). More time is needed to study the effects on the municipal bond market wrought by these laws. Those provisions which were addressed in TEFRA or the DRA related to tax-exempt financing may now be ripe for review.

SPECIFIC RECOMMENDATIONS

When considering changes to the current treatment of tax-exempt financing that are required to remedy certain real or perceived abusive practices, we urge that our colleagues to identify the real abuses that may exist and draft legislation designed to curb such practices rather than enact provisions similar to those in H.R. 3838 which penalize state and local governments and taxpayers. Without being presumptious, a review of the testimony presented to the Banking Committee compels us to make recommendations regarding H.R. 3838's: (1) application of the alternative minimum tax (AMT) to non-essential function bonds; (2) imposition of volume caps upon and the classification of certain bonds as non-essential bonds; and (3) restrictions on arbitrage, advance refunding and other related practices.

1. Alternative Minimum Tax.—The inclusion of tax-exempt interest on nonessential function bonds as a preference item for pur-

poses of computing the alternative minimum tax (AMT) base will disrupt the investor market and cause interest rates to escalate. Although it is unclear how many taxpayers who invest in municipal bonds will actually have to pay some tax on municipal bond interest, the proposed AMT rules will affect all investors. The proposal will add uncertainty to an otherwise stable and simple investment. Higher interest rates (higher costs to issuers) will result in order to account for this uncertainty and compensate investors not only for the expense and confusion of compliance but also for the risk that the lower yielding tax-exempt bond may in fact be partially taxable. Without reasonable compensation, taxpayers will invest either in essential function bonds only or other taxable investments. Should any revenues be generated for Treasury from this House proposal, it will be primarily at the expense of state and local issuers.

Overall rate reductions alone will have a significant impact on the investor market requiring compensating adjustment in interest rates. As it is, the investor market is limited. Congress does not need to put additional pressure on issuers to compete in this limited market, and tax-exempt interest should remain just that—*tax-exempt*. No tax-exempt interest should be included as a preference item for purposes of computing AMT.

2. Volume Caps and the Classification of Bonds.—H.R. 3838 categorizes bonds issued by state and local governments as either "essential function" or a "non-essential function". This classification is based on a rather arbitrary percentage of non-governmental use involved with the bond-funded facilities or program. Only certain, specified types of "non-essential function" bonds are entitled to tax exemption at all and those "qualified bonds" are subjected to numerous severe restriction, including a very tight state-by-state volume limit based on population.

The classification system proposed by H.R. 3838 constitutes a perversion public policy. First, this unprecedented characterization of bonds issued for housing, higher education facilities, hospitals, sewage disposal facilities, mass commuting facilities, airports, certain water systems and student loans, among others, as "non-essential" represents a misguided and unwarranted intrusion into state and local government decision making. Second, the amount of bonds which states may issue under the proposed volume cap will prove totally inadequate in a majority of states. Third, the standards result in the improbable circumstance of subjecting bonds issued for public facilities such as schools or municipal utility plants to the volume cap because of small amounts of private use (even when the bonds are paid from local taxes or general utility charges). The thrust of these provisions unjustifiably questions the public purpose judgments and authority of local and state governments. They upset sound policy decisions regarding the development of useful public/private joint ventures and the contracting with the private sector to provide better quality governmental services at less expense to the taxpayer.

The "non-essential" terminology should be rejected in favor of a more accurate terminology, that distinguishes between: (1) projects financed by traditional general obligation and revenue bonds; (2) bonds issued for the benefit of non-profit users including hospitals

and universities, mortgage revenue bonds, student loans bonds and bonds for public purpose projects currently deisgnated as "exempt facilities," such as mixed-income rental housing; and (3) bonds issued for corporate related activites such as small issue and pollution control industrial development bonds. Volume caps should be applied only to those bonds issued for corporated related activities. The issuance or bonds in the first two categories noted above should ideally be exempted from any volume cap or, at a minimum, any volume cap applied to these bonds should be raised significantly above the levels provided in H.R. 3838. These more narrowly drawn distinctions could also include requirements deigned: (1) to ensure that public officials demonstrate the adequacy of the public benefit derived from these bonds and (2) to use arbitrage earnings of specific types of public purpose projects to fund those projects.

3. Arbitrage, Advance Refunding and Related Technical Matters.—H. R. 3838 introduces numerous new resteictions, limitations and standards for the issuance of municipal securities. In general, the new provisions are harsh, inflexible, redundant, and, in most cases, increase issuer's costs without any related benefit to the Treasury. Many standards require absolute or "100%" compliance to be satisfied.

The limitations on advance refundings do not permit local governments to take advantage of major improvements in market conditions or credit standing for a broad range of interest-rate-sensitive programs, even though the perceived "abuses" in advance refundings could be cured with relatively few technical adjustments. The new arbitrage, rebate and early issuance provisions have the effect of making perfectly ordinary, long-established, prudent financing and investment practices unavailable. Most of these provisions will result in significant cost increases to state and local governments. Moreover the parties placed at risk by these provisions are the investors in municipal bonds, since noncompliance results in the retroactive loss of tax-exempt status of interest in the bonds.

In view of the broad regulatory power already granted to, and exercised by, the Treasury Department under existing law, the abuses in this area could be remedied by modifications to existing law. Standards for compliance in general should leave reasonable margins of error, such as the well-established "90%" standard associated with the existing "substantially all" test. Advance refundings should remain available as provided in existing law, except that temporary periods for unrestricted investment of proceeds should be reduced and costs which may be recovered should be capped. Other rules concerning temporary periods for arbitrage do not require legislative correction, although the so-called "15% minor portion" allowance could be reduced.

The Finance Committee should also question the wisdom of expanding rebate requirements beyond those imposed under current law, because the imposition of these requirements will increase the costs of financing these projects without providing significant revenues to the Treasury. Rebate requirements might be used instead as a sanction, in lieu of removal of tax exemption, if certain arbitrage rules, such as those concerning timely expenditure of bonds proceeds or those which might be imposed concerning application

of arbitrage to program purposes, are violated. Due to the complications arising from certain state constitutional requirements and the realities of the day-to-day construction and financing public purpose projects, the Finance Committee should seriously consider deleting the proposed early issuance provisions in their entirety.

CONCLUSION

We do not offer these recommendations to detract from the good faith efforts of the authors of Title VII of H.R. 3838. Rather, we submit these views to convey our concerns regarding the potential adverse effects of H.R. 3838 on taxexempt financing. Where abusive practices exist in this area, we urge and will support remedial legislation. However, neither the goals of sound public policy nor tax simplification and fairness are promoted by Title VII of H.R. 3838. Therefore, we urge our colleagues on the Finance Committee and in the Senate to note our concerns and seek to address them in any legislation which they consider.

ALFONSE M. D'AMATO.
MACK MATTINGLY.
CHIC HECHT.
PHIL GRAMM.
CHRISTOPHER J. DODD.
JIM SASSER.

ADDITIONAL VIEWS OF SENATOR GORTON

The Finance Committee's task in drafting comprehensive tax reform legislation is Herculean. While recognizing the special expertise and sole jurisdiction of the Finance Committee in this area, I believe that that committee could benefit from such additional insights as other committees can offer about how tax reform relates to the other questions confronting Congress. For this reason, I believe the chairman of the Senate Banking Committee was wise in calling for hearings on the subject of tax reform and financial institutions. These hearings provided a forum for many knowledgeable individuals to present detailed arguments for and against certain proposals, and for the Senate Banking Committee to evaluate these proposals, probably in somewhat more detail than will the Finance Committee.

A number of important points were made by representatives of various financial organizations during the Banking Committee hearings. The most significant of these are summarized in the statement that precedes this report. I recognize that these hearings, while affording an excellent opportunity for criticism of H.R. 3838, did not always make the opposing point of view clear. For that reason, I think it prudent to make clear that the Banking Committee recognizes this to be the case, and that at least this member feels differently about some of the conclusions that the witnesses offered—embracing some and reserving final judgment on others—while acknowledging the legitimacy of many of the points they made.

I remain particularly concerned over the central role that a stable banking system plays in the American economy. The repeal of the troubled thrift acquisition provisions, of the bad debt reserve allowance tax preference, and of the current law with respect to the foreign tax credit all may have unintended and deleterious effects that it is important to be recognized.

There are various reasons why the current treatment of additions to bank loan loss reserves is appropriate. It is clear that losses in loan asset values occur far in advance of their "recognition" through writeoffs. This is recognized both by regulators, who require banks to reserve accordingly, and by markets, which value a bank's stock according to their views of a bank's exposure to bad loan losses. Given this independent evaluation of a bank's true balance sheet status by the neutral regulators and markets, it seems unfair for the Tax Code to adopt a different view, and one that will systematically overstate (for tax purposes) the real income of banks. Furthermore, it seems especially egregious to do this only for large banks. Such banks, being small in number, may present a convenient political target. But the sort of threshold provision which is included in H.R. 3838 is cynical, and I urge the Finance Committee to reject such arbitrary distinctions.

The proposed imposition of a per-country limitation on the foreign tax credit also charts a dangerous course. On this issue, my objections to H.R. 3838 are rooted more in the immediate problems of the international debt situation than in permanent tax policy, but they are equally strong. The repeal of the current foreign tax credit provisions will make lending to some Third World countries much more expensive, because of the steep gross income taxes those countries impose. At some time in the future, repeal of current law might be justified as a way of leveraging those countries into adopting fairer tax provisions on U.S. lenders. But at the present time, the sad fact is that many U.S. lenders have no real choice but to continue to roll over their maturing foreign debt, and thus the imposition of a per country limitation will be equivalent to a punitive tax to which U.S. lenders will have no hope of responding.

On another subject, I am committed to ensuring that Americans of all income levels have access to affordable housing. I recognize the special concern of the Finance Committee with curbing certain abusive tax shelters, and agree with this goal. I hope, however, that in curbing these shelters the Finance Committee would also not eliminate all of the special housing preferences that have contributed to making America the best-housed of all nations.

Similar comments apply to tax-exempt financing. Like many of my colleagues, I am concerned about the over 400-percent jump in the volume of such financing since 1975. Federal policy toward the issuance of tax-exempt debt must balance the special interest which the privilege of issuing such debt carries with it against the general interest in ensuring that our capital is always invested most productively. The net effect of permitting two classes of borrowing—one taxable and the other tax exempt—is to redirect resources away from higher payoff investments and toward lower payoff investments. This is admittedly an anti-growth strategy.

There are certainly, however, cases where it is reasonable to accept this tradeoff because the tax-exempt investment carries with it other social benefits. I support the Finance Committee's efforts to ensure that tax-exempt borrowing is allowed only when clearly justified by the presence of such social benefits, but I also urge it not to neglect, in any excess of zeal, the very real—albeit often extra-economic—benefits that these investments often have.

Along these lines, I strongly support the Committee's finding that the January 1, 1986, effective date contained in H.R. 3838 is creating the most serious problems in the bond markets, and urge them to indicate clearly a desire for a prospective, rather than retroactive, effective date in this area.

SLADE GORTON.

ADDITIONAL VIEWS OF SENATORS PROXMIRE, CRANSTON, AND SARBANES

During its 3 days of oversight hearings on H.R. 3838, the Senate Committee on Banking, Housing, and Urban Affairs heard from 31 witnesses representing business and financial trade associations and State and local governments. These witnesses provided the Committee with first-hand knowledge about how H.R. 3838 would affect their industries. Their testimony has been summarized in the report of this Committee and should provide the members of the Finance Committee with useful information on some of the serious problems in H.R. 3838.

Although we believe the views represented before the Banking Committee should be given the most serious consideration by the Finance Committee before arriving at any decision on the 1986 tax reform bill, we do not necessarily endorse—nor do we necessarily oppose—the Banking Committee's Findings and Conclusions as indicated in the Committee's report. The Banking Committee heard only from witnesses who would be adversely affected by H.R. 3838. While many of the items criticized in the House bill were also included in President Reagan's tax reform initiative, the Banking Committee did not take testimony from the Treasury concerning the tax reform rationale for these recommendations. Nor did it hear from independent tax experts or economists on H.R. 3838. Nor did the Banking Committee investigate the positive effects of other features of the bill and systematically weigh these features against the provisions criticized by our witnesses. For example, while most economists acknowledge the repeal of certain tax advantages will have an adverse effect on business, some economists argue that these adverse effects will be more than offset by the stimulative effect of lower marginal tax rates and greater tax simplicity.

Similarly, a convincing case can be built for just about any tax preference built into the Tax Code when considered separately from all other tax preferences. However, the arguments for numerous individual incentives must be seen in the context of a broader, equitable and simplified tax system and weighed in that context. Such a procedure is outside the purview of the Banking Committee, whose legislative expertise extends only to certain industries in banking, housing, and finance.

In summary, while we do not believe the Banking Committee hearings record by itself provides definitive support for all the Committee's findings and recommendations, we nonetheless share many of the serious concerns raised by Committee witnesses with respect to H.R. 3838. We urge that these concerns be given the fullest possible consideration by the members of the Finance Committee in reaching their recommendations on H.R. 3838.

WILLIAM PROXMIRE.
ALAN CRANSTON.
PAUL SARBANES.

○